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PRINCIPLES AND PRACTICE

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A Report To The 53rd Legislature

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AN OVERVIEW OF TAXATION IN MONTANA:
PRINCIPLES AND PRACTICE

A Report to the 53rd Legislature

from the

REVENUE OVERSIGHT COMMITTEE

Prepared by
Jeff Martin, Staff Researcher

November 1992

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Montana Legislative Council
Room 138, State Capitol
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INTRODUCTION

HOUSE JOINT RESOLUTION NO. 55 -- THE STUDY

House Joint Resolution No. 55, passed by the 52nd Legislature, requested that the Revenue Oversight Committee study all aspects of taxation in Montana. In its study, the Committee was directed to:

- examine existing sources and levels of taxation, with particular attention given to the classification of property and the taxable percentages applied to that property, and evaluate the sources and levels of taxation;

- examine alternative methods of taxation from existing sources as well as new sources of revenue, such as broadening the property tax base to include, among other things, stocks and bonds, and evaluate the alternative methods and new sources; and

- develop recommendations for a balanced and integrated tax structure for the state.

The resolution did not provide the Committee with additional financial or staff support to conduct such an extensive study of Montana's tax structure.

RECENT ATTEMPTS OF TAX REFORM AND ADOPTION OF STUDY PLAN

In the last three regular sessions (1987, 1989, and 1991) and in the June 1989 Special Session, the Montana Legislature has struggled with the issue of general tax reform. The particular interest in general tax reform in the recent past was inspired by the passage of the property tax freeze contained in Initiative Measure No. 105, by concern that the state's tax system impedes economic development, and by a desire to improve tax fairness and simplicity. Tax reform efforts in the 1987 and 1989 Regular Sessions and the June 1989 Special Session included income and property tax reform and proposals for the imposition of a general sales tax. In the 1991 Legislative Session, a statewide general sales tax never became an issue, and most tax reform measures dealt only with property taxation. The Legislature also considered measures that would provide for the imposition of a state income tax based on a percentage of federal income tax liability and that would allow local governments to raise revenue through local option taxes.

Because no measure introduced since 1987 that addresses the issues relating to general tax reform has been enacted, House Joint Resolution No. 55 requested an all-inclusive study to examine the fundamental issues of taxation and, by implication, expenditures.

At its May 31, 1991, meeting, Revenue Oversight Committee staff presented a comprehensive study plan to the Committee. The following elements were included in the study plan:

- a general discussion of taxation at the state and local level (a tax primer);
- a description of the criteria for evaluating state and local tax systems;
- a historical analysis of revenue and expenditure patterns both in Montana and in other states;
- an inventory of the components of Montana's tax system;
- an analysis of Montana's tax system in relation to the state's economy;
- an analysis of state and local budgeting;
- an analysis of nontax revenue;
- state revenue and expenditure projections through 1995; and
- a discussion of revenue options for state and local governments.

The study plan encompassed an exhaustive examination of the state's fiscal and economic structure. As presented to the Committee, the study plan represented a task that would require substantial financial commitment and the participation of many individuals with expertise in public finance and economics. The Committee's budget, however, allocated only $5,000 for consulting services. This amount was not specifically budgeted for a tax study, but rather for any technical assistance the Committee might require during the interim. The Committee did not adopt the study plan at the May 31 meeting but directed staff to prepare a background report (tax primer) for the Committee's consideration.

At its August 2, 1991, meeting, the Committee, undaunted by the lack of resources to conduct the study, adopted the staff study plan. The Committee also voted to form a subcommittee to review the study plan and a similar proposal prepared by KPGM Peat Marwick (*A Proposal to Study the Montana Economy and State and Local Fiscal System*) and presented to the Montana Tax Reform Coalition. The subcommittee was directed to meet with interested groups and make recommendations to the full Committee regarding the course of the study. Subcommittee members included Sen. Dorothy Eck (Chair), Sen. Bruce Crippen, Rep. Mike Foster, and Rep. Dan Harrington.

STUDY PLAN MODIFIED

The subcommittee met September 17, 1991, to consider options for undertaking a study of Montana's tax structure. The subcommittee invited Robert Ebel, Director, State and Local Services, Policy Economics Group, KPGM Peat Marwick, to discuss the process and structure of a comprehensive tax study. Mr. Ebel reviewed the House Joint Resolution No. 55 study plan and the study proposal submitted by Peat Marwick to the Montana Tax Reform Coalition. The purpose of Mr. Ebel's presentation was to provide the subcommittee insights on the kind of information and analyses that should be included in a tax study.

He suggested that a thorough review of the state's economic and demographic trends is necessary to determine whether the existing tax structure can support current level services in the long term. The study should contain, among other things, a thorough description of the existing tax system as well as alternatives for capturing the changes of an evolving economy in the tax system. Mr. Ebel emphasized that public participation is vital to the success of any tax study.

Mr. Ebel also described tax studies that have been completed in other states. He noted that comprehensive tax studies typically cost several hundred thousand dollars. The cost includes an analysis of the state's economic system and tax structure, compilation of tax data bases, and the development of economic and tax models for revenue forecasting and simulation of various tax scenarios.

Following Mr. Ebel's presentation and public comment,* the subcommittee concluded that the Revenue Oversight Committee did not have the financial resources or sufficient staff resources to undertake a tax study of the magnitude suggested by the Peat Marwick proposal or the staff study plan. Subcommittee members unanimously agreed to recommend to the full Committee that other options, including a request for an adequate appropriation from the Montana Legislature, be considered for completing a tax study.

At its October 4, 1991, meeting, the full Revenue Oversight Committee informally concurred with the subcommittee's conclusion that a comprehensive tax study could not be completed by the Committee because of a lack of adequate resources. The Committee, however did not entirely abandon the tax study. It directed staff to gather as much information as possible on state and local taxation in general and on the Montana tax structure in particular.

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* See the September 17, 1991, subcommittee minutes for the Peat Marwick proposal and a roundtable discussion of the tax study.

This report is a culmination of a series of reports presented to the Revenue Oversight Committee on the principles of state and local taxation, as well as an analysis of certain components of Montana's tax structure. It is divided into five chapters. Chapter One discusses the general principles of state and local taxation. Chapter Two describes the criteria for evaluating state and local tax systems. Based on the information in Chapter Two, the Committee held a public forum to further explore the criteria for judging tax systems. Chapter Three summarizes oral presentations and written material provided by nine panelists at the public forum. Chapters Four and Five discuss the Montana individual income tax structure and the Montana corporation income tax, respectively.

The appendix to this report contains four reports presented to the Revenue Oversight Committee by the Montana Department of Revenue. The first report shows individual income tax liabilities since 1981 and analyzes the impact of the indexation of taxable income brackets during the same period. The second report summarizes the number of corporation income tax returns filed by industrial sector and shows the revenue impact of imposing a graduated rate structure on the net income of corporations. The third report analyzes the property tax component (the taxation of property at 100 percent of market value) of the tax reform proposal advocated by the Montana Association of Counties. The last report discusses the value-added tax concept and the implications for Montana if the state were to impose a value-added tax on business activity.

The perspective of this report is backward-looking. That is, the report primarily explores the Montana tax system during the recent past. No attempt was made to examine the revenue implications from alternative methods of taxation. For this and other reasons, the Revenue Oversight Committee does not offer recommendations or a list of options for the Legislature's consideration.

CHAPTER ONE

PRINCIPLES OF STATE AND LOCAL TAXATION

I. INTRODUCTION

Despite general consensus on the need for comprehensive tax reform, actual changes in state and local tax policy have often been difficult to achieve not only in Montana, but in other states as well. Tax reform is akin to a somewhat seamier issue in the public eye: "I can't define tax reform, but I know it when I see it." People and institutions advocate tax reform for a variety of admirable reasons: fairness, simplicity, revenue diversification and stability, and economic development. These goals for tax reform can generate conflict, as between, for example, tax fairness and economic development.

Recently, the Citizens for Tax Justice issued a report[1] charging that state and local tax structures around the country are regressive and that lower- and middle-income persons pay disproportionately more in taxes than do the wealthy. The report calls for more reliance on progressive income taxes and less on consumption taxes. An editorial in the Wall Street Journal assailed the report, claiming that most Americans prefer lower taxes and state policies that leave economic decisions in their hands.[2] It is arguments such as these that often give tax reform high marks in rhetoric but low marks in actual implementation.

Tax reform is a complicated issue and difficult to achieve. A general understanding of taxation as well as an analysis and evaluation of a state's tax structure are important components in determining the appropriate direction of tax reform measures. This chapter does not address tax reform, but rather outlines some basic principles related to state and local taxation and then describes the major state and local taxes levied in the United States. The Appendix to the chapter contains a glossary of terms used in taxation and public finance analysis.

II. ANALYSIS AND EVALUATION OF TAXATION

STATE AND LOCAL TAXATION

The U.S. Bureau of the Census defines taxes as a compulsory contribution exacted by a government for public purposes.[3] The basic purpose of taxation at the state and local level is to raise revenue for governmental expenditures. In the process of imposing taxes, state and local governments allocate tax burdens. Tax burdens lead to a reduction in private disposable income and thus a reduction in the demand for private goods. The tax burden, however, is not always borne by the taxpayer legally required to pay the tax. The person who initially pays the tax (referred to as tax impact) may be able to pass all or a portion of the tax to someone else. This process is referred to as shifting. For example, businesses typically do not bear the economic burden of a tax. Instead, the tax may be passed on to owners as smaller profit, to consumers as higher prices, or to workers as lower salaries. When individuals cannot shift a tax, they are said to bear the incidence of the tax.

There are equity implications associated with shifting depending on the income characteristics of the group bearing the incidence of the tax. It must be kept in mind, however, that tax incidence refers to only one side of the fiscal equation. Because public expenditures may redistribute wealth, the level and incidence of public expenditures should also be taken into account when analyzing tax incidence.

PRINCIPLES OF TAX EQUITY

Although issues such as who should bear the burden of taxation and who, in fact, does bear the burden may be of secondary concern when taxes are imposed to finance or increase government services, they are important policy considerations nonetheless. These issues may be resolved in part by the standards of equity and good government held by the dominant political organizations and individuals.[4] The common thread underlying these issues of taxation is the notion of tax fairness.

In democratic societies, there is near universal agreement that everyone should bear his or her "fair share" for the cost of government. There is, however, no general agreement on how "fair share" should be defined.

Benefits-Received Principle

There are two concepts that attempt to assess, based on value judgements, an equitable tax system. One concept is the benefits-received principle. The principle states that those who enjoy the benefits from goods and services provided by government should bear the burden of taxation in proportion to the amount of benefits received. Thus, each taxpayer would be taxed according to his or her demand for public services. As a theoretical concept, the benefits-received principle links the expenditure and revenue sides of the budget and also links tax burdens with benefits derived from government as a measure of equity. Full application of the benefits-received principle, however, would require governments to identify those who benefit and determine the value of benefits received. In addition, it would be extremely difficult in most cases to exclude nontaxpayers from receiving benefits.

The idea of a general benefit tax is therefore of interest mainly as a theoretical concept. A limited practical application of the principle may be made by fees or user charges or by the taxation of motor fuels for highway purposes. User charges may be used when goods and services provided by government are similar to private goods, the provision of which approaches an economic exchange.

When the imposition of a user charge is impractical or too expensive, a tax on a complementary product in lieu of a charge may be imposed.[5] A motor fuel excise tax is the most common example of this type of tax. Revenue from this source is typically (but not always) earmarked for highway finance.

A motor fuels tax, however, only approximates the benefits-received principle. For example, the tax paid by one driver may be applied to a highway used by another or the tax paid by one class of highway users (e.g., a motor carrier) may not fully cover its cost of using the highway.

Other examples of benefits-received taxation may include special assessment property taxes, value-added taxes, and gross receipts taxes. With respect to value-added or gross receipts taxes on business, the presumption is that business, whether profitable or unprofitable, benefits from governmental services and should expect to pay for them.

Taxes in general may be thought of as payments for benefits received by the public for governmental services. People would be unlikely to support a governmental program if they did not benefit, at least indirectly, from the program. As noted above, however, to allocate the tax burden based on benefits received by any one individual would be impractical. The benefits of governmental services are usually received by groups rather than by individuals. Indeed, that is the primary justification for governmental activity.[6] Society generally regards the provision of such services as schools, prisons, welfare, and national defense as desirable collective undertakings through government. In addition, tax payments, unlike user fees, do not give rise to specific services in return and do not constitute an exchange in the usual economic sense.

Ability-to-Pay Principle

The alternative equity principle is the ability-to-pay principle. Under this principle, the amount of taxes should be related to an individual's ability to pay based on economic well-being. Income is a commonly accepted measure of ability to pay. Many definitions have been used in determining income. They range from adjusted gross income for federal or state income tax purposes to permanent or lifetime income. Adjusted gross income may be too narrow a definition because it does not include all of a person's economic capacity and hence ability to pay taxes. Permanent income may be too broad a definition because it attempts to measure the flow of income over a lifetime and is too far removed from current policy considerations. A more realistic concept of income would include money income (from whatever source), imputed income (e.g., imputed rent from owner-occupied housing), and the appreciation of assets.[7]

Taxation based on the ability-to-pay principle implies both horizontal and vertical equity. Horizontal equity means that persons of roughly equal economic capacity and receiving the same services should pay the same amount in taxes. With respect to income taxes, the horizontal equity criterion is violated by such provisions that enable a homeowner to deduct mortgage interest payments or by preferential treatment of certain sources of income, such as capital gains exclusions or retirement income exemptions.

Vertical equity implies that persons with greater economic capacity should pay more. Vertical equity can be measured in terms of whether the tax is progressive, proportional, or regressive according to whether payments rise, are constant, or fall as a proportion of income as income rises.

III. ADMINISTRATIVE AND COMPLIANCE COSTS

Administrative costs are the costs to government for levying and collecting taxes. Administrative costs will vary from tax to tax and by the complexity of the tax. An income tax is typically more costly to administer than a sales tax; a narrow-based sales tax is more costly than a broad-based sales tax.

Compliance costs are the costs incurred by the taxpayer both in time and money to keep the necessary records and actually pay the tax. Because of the complexity of personal income taxes, compliance costs for this tax can be high. Obviously, the cost for some taxpayers will be higher than for others depending on whether the taxpayer itemizes deductions or whether the taxpayer uses an accountant or lawyer to prepare the return. While compliance may be costly to the taxpayer, it is justified by a more equitable outcome.

IV. REVIEW OF MAJOR TAXES LEVIED IN THE UNITED STATES

The major taxes levied by state and local governments are the property tax, the income tax, the sales tax, and, to a much lesser extent, selective excise taxes, including motor fuels taxes and motor vehicle license taxes. Table 1 shows the amount and relative proportion contributed by each of these taxes for state and local governments in 1980 and 1989.

Table 1: Tax Revenue of State and Local Governments in the United States by Source, 1980 and 1989 (Millions of dollars)

Type of Tax	1980	Percent of Total	1989	Percent of Total
Property	68,498.7	30.7%	142,524.7	30.4%
Sales	51,327.6	23.0%	112,597.6	24.0%
Motor fuels	9,821.6	4.4%	18,642.5	4.0%
Motor vehicle license	5,324.0	2.4%	10,043.6	2.1%
Income	55,401.1	24.8%	123,728.8	26.4%
Other	33,089.6	14.8%	61,110.3	13.0%
Total	223,462.6	100.0%	468,647.5	100.0%

Source: U.S. Bureau of the Census, Government Finances.

Nationwide, property taxes provided 30.4 percent of all state and local tax revenue in 1989, followed by income taxes (individual and corporation) at 26.4 percent and general sales taxes at 24 percent. All other taxes provided 21.6 percent. Little change occurred in the relative contribution of each tax between 1980 and 1989. Overall, state and local tax collections increased by about 110 percent between 1980 and 1989 or by an 8.6 percent annual rate.

Table 2 shows similar information for Montana. Property taxes provided 43.6 percent of state and local taxes, followed distantly by income taxes (again individual and corporation) at 25.6 percent. Income taxes in Montana provide about the same proportion of total taxes as they do nationwide. Total tax collections in the state increased by about 60 percent between 1980 and 1989 or by a 5.3 percent annual rate.

Table 2: Tax Revenue of State and Local Governments in Montana by Source, 1980 and 1989 (Millions of dollars)

Type of Tax	1980	Percent of Total	1989	Percent of Total
Property	358.3	45.5%	547.4	43.6%
Motor fuels	51.1	6.5%	107.0	8.5%
Motor vehicle license	28.6	3.6%	42.8	3.4%
Income	180.6	23.0%	321.7	25.6%
Other	168.2	21.4%	237.9	18.9%
Total	786.8	100.0%	1,256.8	100.0%

Source: U.S. Bureau of the Census, Government Finances.

PROPERTY TAXATION

Property taxation is one of the most ancient forms of taxation, probably originating with the beginning of government[8], and has been a major source of revenue for governments in the United States since its founding. However, with the advent of other types of taxes at the national and state levels, property taxation has become primarily a local government tax.

In its most comprehensive form, the property tax base would include all real property and improvements, producer and consumer durable goods, business inventories, and financial assets. The general ad valorem property tax that emerged in the nineteenth century in the United States included the taxation of both tangible and intangible personal property. However, almost since the inception of general ad valorem property taxation, states began providing exceptions, especially for personal property.[9] In addition, states have adopted "relief" provisions, including homestead exemptions, use-value of agricultural land, and circuit breakers for low-income individuals.

The erosion of the property tax base, increased revenue diversification, and state aid for such things as public schools has caused the property tax to decline in relative importance. Property taxes fell from 46 percent of all state and local tax collections in 1962 to just over 30 percent in 1989. In Montana, property taxes fell from 57 percent of total collections to 46 percent during the same time period.

Property taxes are levies on tangible property, including land and improvements and personal property, and to a much lesser extent on intangible property. The tax bill under the property tax is determined by multiplying the tax rate times the value of the property. Because property, especially real property, is sold infrequently, the value is usually determined by assessment or appraisal by a public official.

Property may be taxed uniformly or under a classification system. Under a uniform system of taxation, all property, real and personal, is assessed at market value and all property is subject to the same statutory tax rate. Under a classification system, different tax rates (the amount of tax as a percentage of market value) are established for different types or "classes" of property. The classification system assigns every taxable piece of property to a particular class and establishes interclass differentials.[10]

From an equity viewpoint, there is a question of whether the value of property is a good measure of ability to pay. The value of a person's property may be indicative of benefits received for certain public services, such as public education and public safety. On the other hand, the value of property may not reflect benefits received for other governmental services, and the value of a person's property may not be closely related to income. Also the property owner may face relatively high tax burdens in relation to the level or quality of services provided.

There is a tendency for property values to be capitalized to reflect tax liability and the level of government services. Capitalization refers to the adjustment in the price of an asset that takes into account the stream of future benefits and costs associated with ownership of the asset. The market value of property may be higher in areas where there are high levels of desirable public services. People are willing to pay more for housing in these areas, and the value of the amenities of the public services are capitalized into higher market values. Conversely, the market value of property may be lower in areas where tax liabilities are high without offsetting high levels of public services.

INDIVIDUAL AND CORPORATION INCOME TAXES

Individual Income Taxes

The use of individual income taxes as a source of state revenue is a creature of the twentieth century. Hawaii first imposed a tax on individual and corporate income in 1901. Wisconsin adopted income taxes in 1911. By 1969, the individual income tax was employed in 40 states and the District of Columbia. Three other states have limited forms of income taxation. New Hampshire and Tennessee tax interest and dividend income, while Connecticut taxes capital gains and dividend income. Seven states, Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming, do not impose individual income taxes.

State income taxes in most states are patterned after federal income tax provisions that allow personal exemptions and deductions to arrive at a net personal income tax base. The key concept in determining taxable income is adjusted gross income.[11] Income from all sources, except income specifically excluded, is combined to arrive at total income. Sources of income include wages and salaries, net business income, retirement income, interest and dividend income, capital gains (or losses), etc. From total income, certain deductions are allowed to arrive at adjusted gross income. In most states, other additions (e.g., interest on out-of-state government bonds) and reductions (e.g., capital gains exclusions) are included to arrive at in-state adjusted gross income. Adjusted gross income is further reduced by allowable deductions (standard or itemized) and personal exemptions to arrive at taxable income.

Tax liability is computed by applying legislated marginal tax rates on successive increments of taxable income. The rate schedule may be fairly narrow, as it is in Maryland and Minnesota, or fairly broad, as it is in Montana. Several states (e.g., Illinois, Indiana, Michigan, and Pennsylvania) impose a single rate on all taxable income. Tax liability may be further reduced by allowable tax credits.

Increasing marginal tax rates and the use of personal exemptions tend to make the income tax progressive. Marginal tax rates, however, do not necessarily indicate the degree of progressivity of the tax. So-called tax loopholes can offset the progressivity implied in marginal tax rates. Conversely, progressivity in the income tax structure can be maintained with personal exemptions and a single tax rate. One way to determine the progressivity of the income tax is to examine effective tax rates or tax liabilities as a percentage of adjusted gross income.

Corporation Net Income Taxes

The corporation net income tax is used in 44 states and the District of Columbia. Michigan, Nevada, South Dakota, Texas, Washington, and Wyoming do not tax corporations on the basis of net income. Michigan imposes a value-added tax, Texas imposes a franchise tax based on net equity, and Washington imposes a gross receipts tax.

Taxes on corporate net income differ significantly among the states in terms of tax rates, method of apportionment, and definitions of the taxable unit and taxable income.[12] In general, net income is determined by subtracting external purchases and internal costs from gross receipts.

There are two major rationales for taxing the net income of corporations. The first is to protect the individual income tax base by including retained earnings in the corporation tax base. If this were not the case, shareholders could hide income within the corporation. The tax on retained earnings could impose vertical inequities among shareholders because lower-income shareholders may be overtaxed depending on the rate structure faced by the corporation. In addition, there is the problem of double taxation when dividends are paid out. If the corporation tax is not paid by shareholders but is shifted to workers (through lower wages) or consumers (through higher prices), both horizontal and vertical inequities may arise.

The second rationale for taxation of corporations is the benefits-received principle. Corporations receive many services from state and local government. Net income, however, is a poor measure of the value of services provided. Obviously, corporations with no net income are not taxed for services. To the extent that a benefit tax is appropriate for corporations, other tax bases may better reflect the value of services received. For example, real estate would reflect the value of such services as police and fire protection. As noted above in the general discussion on the benefits-received principle, value-added taxes, which include profits as well as factor costs, could serve as a general proxy for benefits received.

CONSUMPTION AND EXCISE TAXES

General Sales Taxes

Sales taxes are of more recent vintage than income taxes. Mississippi first imposed a sales tax in 1932, followed by 26 other states between 1933 and 1938. Declining revenues from other sources, particularly the income tax, rising costs for relief programs, and participation in federal programs during the depression led many states to adopt the sales tax in the 1930s.[13] Forty-five states and the District of Columbia now impose general sales taxes. Five states, Alaska, Delaware, New Hampshire, Montana, and Oregon, do not have a general sales tax. In 1989, general sales taxes accounted for 24 percent of all state and local tax revenue (see Table 1) and for 33 percent of all state government tax revenue.

General sales taxes are taxes on consumer purchases but usually include business purchases as well. In most states, sales taxes may be typified as general sales taxes on tangible personal property and selective excise taxes on service transactions.[14] In an attempt to reduce the regressive features of sales taxes, many states have been narrowing the tax base by exempting such items as food, prescription drugs, utilities, goods subject to excise taxes, and other items that are politically attractive to exempt from the tax. The base narrowing, however, has generally led to higher statutory rates and increased administrative and compliance costs. Exemptions tend to favor consumers with heavy expenditures in these transactions. For example, the exclusion of services from the tax base discriminates against consumer preferences for goods.

Excise Taxes

Selective excise taxes are levies on the sale of particular goods or services apart from a general sales tax. With the exception of motor fuels taxes, they are typically minor components of a state's revenue structure. At the state level, selective excise taxes generally include user charges and sumptuary (or sin) taxes. Motor vehicle taxes and gasoline taxes are the most common examples of a charge for the use of goods and services provided by government. These taxes are correlated with the use of roads and, as noted previously, embody the benefits-received principle. Sumptuary taxes are levied on goods that society regards as undesirable. An additional rationale for sumptuary taxes is that they internalize the costs to society that may occur as a result of using the product. Cigarette taxes and alcohol taxes are the most obvious examples.

Excise taxes tend to be regressive and are often thought to be unfair using the ability-to-pay criterion. If excise taxes are a source of general fund revenue, they may be inequitable. They may not be unfair if they are levied as user charges, as is the case for most motor fuels taxes.

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13. John F. Due and John L. Mikesell, Sales Taxation: State and Local Structure and Administration, (Baltimore: Johns Hopkins University Press, 1983), p. 2.

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CHAPTER ONE
APPENDIX

APPENDIX

Glossary of Selected Terms Used in Taxation and Public Finance Analysis

Ability-to-Pay Principle--The equity viewpoint that the amount of tax burden should be related to an individual's economic ability to bear the burden.

Alternative Minimum Tax--The tax imposed on individuals and corporations to ensure that all taxpayers pay at least a minimum amount of taxes. The tax rate is a fixed percentage of alternative minimum income.

Appraisal--An opinion, usually in writing and from a specialist, of the monetary value of property. The appraisal incorporates all relevant factors, including cost of the property, depreciation, ability of the property to earn income, and sales price of similar properties.

Assessment--The process used to determine the fair market value of property for property tax purposes. The terms appraisal and assessment are often used interchangeably.

Assessed Value--The dollar amount officially set as the valuation of a specific property for tax purposes. The amount may or may not be the same as the gross or net assessed value.

Benefit Principle--The equity viewpoint that individuals who receive benefits from goods and services provided by government should bear the tax burden in proportion to benefits received.

Capitalization of a Tax--The change in the market value of an asset as a result of a change in the level of taxation that applies to the asset.

Capital Levy--A tax on net worth (i.e., assets minus liabilities).

Capital Stock Base--The portion of business net equity (capital and surplus) and, in some cases, long-term debt that is subject to taxation. The tax is on a measured economic stock (capital) as opposed to an economic flow (income).

Cigarette Tax--An excise tax on the sale of cigarettes.

Classified Property Tax System--A property tax in which the assessed value of different types of property is multiplied by different percentages to determine the taxable value of the property.

Compliance Costs--The costs (direct and indirect) incurred by a taxpayer in keeping necessary records for and actually paying the tax.

Corporation Income Tax--A tax on the net income (gross receipts from sales, rents, and interest, less ordinary expenses) of a corporation.

Depletion Allowance--An amount that may be subtracted from gross income to compensate for the reduction in the value of natural resources (from mines, wells, or timberlands) as a result of severance or production. The amount of the depletion allowance may be determined by the cost method (cost of units produced divided by recoverable units) or by the percentage method (fixed percentage of gross income).

Direct Tax--A tax borne by the individual on whom it is levied.

Earned Income--Income from wages and salaries and from self-employment as opposed to income from property, dividends, and interest.

Economic Effects of Taxation--Changes in economic behavior of individuals or business firms as a result of a tax or tax system.

Effective Tax Rate--A relative measure of tax burden that relates taxes paid to some variant of income.

Equalization--The process of adjusting all assessed valuation within a taxing jurisdiction by a stated percentage for the purpose of making the percentage of assessed value to market value of property in the jurisdiction the same as other taxing jurisdictions.

Equity of Taxation--The fairness of taxation.

Excess Profits Tax--A tax levied on profits that are beyond the normal profits of a business. Excess profits may be measured against a base period or against a standard rate of return on invested capital. An excess profits tax is generally imposed during a national emergency, such as war, to discourage profiteering.

Excise Tax--A tax on the manufacture, sale, or consumption of commodities.

Expenditure Tax--A tax on the amount of spending or consumption by an individual during a year.

Franchise Tax--A tax on the privilege of carrying on business in the form of a corporation.

Gasoline Tax--An excise tax on the sale of gasoline.

General Sales Tax--A tax at some percentage of the retail sales price of most goods and, in some cases, services. The tax may be a direct tax paid by the purchaser or a turnover tax paid by the seller on gross sales.

Gross Income Tax--A tax on the total income of individuals and businesses without allowance for expenses and deductions.

Gross Receipts Tax--A tax on all sources of business income. It is essentially a multistage sales tax paid by business rather than consumers.

Income Elasticity of Tax Revenue--The responsiveness of tax revenue to changes in personal income over time. It is the ratio of the percentage change in tax revenue to the corresponding change in personal income between two time periods.

Indirect Tax--A tax on some right or privilege or corporate franchise. Also a tax the burden of which does not fall on those who bear its impact.

Individual Income Taxes--Taxes on individuals measured by adjusted gross income or net income and including distinctive taxes on income from interest, dividends, and the like.

Intangible Personal Property--A nonphysical asset that is representative of value, such as stocks, bonds, promissory notes, goodwill, patents, and franchises.

Investment Tax Credit--A percentage of the purchase price of capital goods and equipment that may be subtracted from the tax liability of a business.

Liquor Tax--An excise tax on the sale of alcoholic beverages.

Locked-In Effect--A predicament of one who has profits on securities that the individual is unwilling to sell because of the liability for capital gains.

Mill Levy--The rate of property tax expressed as number of mills. A mill is one-tenth of a cent and is generally expressed in terms of mills per dollar of taxable value.

Net Worth Tax--A tax on the net worth (assets minus liabilities) of an individual or business.

Payroll Tax--A tax on the wages and salaries paid by a business. A payroll tax is generally used to finance such things as social security and unemployment compensation benefits.

Progressive Tax--A tax in which the relative tax burden rises as income rises.

Property Taxes--Taxes based on ownership of property and measured by its value. They include general property taxes relating to property as a whole, real and personal, tangible and intangible, whether taxed at a single rate or at classified rates (as in Montana). They also include taxes on selected types of property, such as motor vehicles or specified intangibles.

Proportional Tax--A tax in which the relative tax burden remains roughly the same across the income spectrum.

Regressive Tax--A tax in which the relative tax burden declines as income rises.

Severance Taxes--Taxes imposed on the removal of natural resources, such as oil, gas, other minerals, timber, and fish.

Shifting--The process by which a tax is passed from its initial point of legal impact to its final economic resting place.

Sumptuary Excise Tax--A tax on the sale of a product the use of which is considered harmful or extravagant by society. Also known as "sin taxes".

Tax Avoidance--The minimization of one's tax liability by taking advantage of legally available tax planning opportunities.

Tax Burden--The effective tax rate or actual taxes paid as a percentage of income. The term refers to individuals whose income is ultimately reduced as the result of a tax.

Tax Evasion--The illegal nonpayment of taxes due.

Tax Exporting--The movement of a tax out of a political jurisdiction onto residents of another jurisdiction or onto the federal revenue system.

Tax Impact--Refers to the individual or business that has the legal liability to pay a tax regardless of whether the taxpayer bears the burden of the tax.

Tax Importing--The movement of a tax from some other jurisdiction into a specific political unit to become a burden on its residents.

Tax Incidence--The actual economic impact of a tax on those who ultimately bear its burden.

Tax Preference Items--Certain tax benefits that must be considered in calculating a taxpayer's alternative minimum tax. The benefits are deducted in arriving at taxable income for regular tax purposes and added back in arriving at taxable income for alternative minimum tax purposes.

Taxable Valuation--The percentage of assessed value of property that is subject to taxation in Montana. The percentage varies according to the class of property.

Undistributed Profits Tax--A tax imposed on the retained earnings of a corporation.

Unitary Tax--A method of determining the locally taxable income of businesses that transact business with affiliated companies outside the state. Sales, property, and payroll of related corporations are combined for nexus and apportionment purposes, and the income of the unitary entity is apportioned to the state.

Use Tax--A tax on the use, consumption, or storage of tangible personal property, generally at the same rate as the sales tax. The use tax is designed to prevent people from avoiding the sales tax by purchasing items outside the state.

Value-Added Tax--A tax assessed on goods and services on the value added by each producing unit. Value added may be measured in terms of the total sale price of output minus the cost of raw materials and intermediated goods purchased from other firms. The amount of the tax is a percentage of the value of the goods or services. Michigan is the only state that uses a value-added tax.

Weight-Distance Tax--The taxation of motor carriers based on declared weight and miles driven. The tax rate generally increases as the weight capacity of the motor vehicle subject to taxation increases.

CHAPTER TWO

CRITERIA FOR EVALUATING STATE AND LOCAL TAX SYSTEMS

I. INTRODUCTION

In a study similar to the one contemplated by House Joint Resolution No. 55, the Texas Select Committee on Tax Equity identified nine criteria for judging a "good" tax system: adequacy of revenue, equity, efficiency, stability, economic competitiveness, simplicity, balance, breadth of tax base, and intergovernmental linkages.

The Texas Select Committee collapsed these criteria into four broad categories:

Adequacy of Revenue. A "good" tax system should produce adequate revenue to fund governmental services in a stable and predictable manner. The tax system should make use of a wide variety of revenue sources with the widest possible bases.

Equity. A "good" tax system should be fair, both to individual citizens and to businesses operating in the state.

Economic Efficiency. A "good" tax system should not unnecessarily or unintentionally interfere with private economic decisions. It should be competitive with the tax systems used in other states, but it should not rely heavily on tax incentives that favor certain businesses or industries to the exclusion of others.

Simplicity. A "good" tax system should be as simple as possible to administer for both the taxpayer and the tax collector.[1]

Steven Gold, Director of the Center for the Study of the States, echoed these criteria in the cover letter to a recent survey on tax reform conducted by his agency when he indicated that effective tax reform involves

> . . . policies that remove exemptions or deductions or grant new ones, and changes that make the tax system more balanced or more stable, easier to administer, comply with, and understand, less regressive,more supportive of economic development, or more neutral.[2]

Other states that have undertaken comprehensive tax studies have generally used the same criteria described above.

The purpose of this chapter is to briefly describe criteria that may be used to evaluate state and local tax systems. The criteria discussed in this report include adequacy and stability of revenue, equity, economic efficiency (or neutrality) and tax competitiveness, and simplicity. This chapter presents concepts for consideration that may be further explored and developed in technical analyses of Montana's state and local tax structure.

II. ADEQUACY AND STABILITY OF REVENUE

According to the criteria identified by the Texas Select Committee on Tax Equity, the first requirement of a tax system is to raise the required revenue to support the activities of government. The tax system should have the capacity, allowing for normal fluctuations, to provide a stable and predictable source of revenue for a given level of governmental services without the constant need for revisions in the tax base or tax rates. The other side of the adequacy criterion is that the tax structure should not generate more revenue than is required to meet government obligations.

PHILOSOPHICAL DIFFERENCES

The revenue adequacy criterion appears to be a reasonable tax policy goal, given some accepted level of public expenditure. The appropriate level of public expenditure, however, is a judgment that is resolved through the political process, and this judgment may change over time. Depending on the dominant view of the desired level of government activity as represented in expenditure patterns, the expression of the revenue adequacy criterion may ebb and flow between the extreme ends of the political spectrum. At one extreme is the view that tax revenue should grow more slowly than the economy. This objective requires elected officials to vote on higher taxes for larger public expenditures, thus ensuring political accountability for increased taxes related to increased expenditures.[3] Reliance on property taxes, sales taxes, and user fees is an expression of this view of revenue adequacy. The indexation of personal income taxes is another expression of this view. At the other extreme is the view that tax revenue should grow at a faster pace than the economy, thus ensuring revenue for perceived social needs while minimizing the political risk of explicitly imposing higher taxes.[4] A tax structure that relies heavily on a steeply graduated progressive income tax is the preferred method of taxation for this view because, as discussed below, a progressive tax tends to grow more rapidly than the economy.

METHODS OF EVALUATING REVENUE ADEQUACY

Income Elasticity Approach

The adequacy of tax revenue is often analyzed in terms of its responsiveness to changes in the economy, usually personal income. The traditional method of measuring the responsiveness of tax revenue relative to changes in personal income over time is the income elasticity of tax revenue. Income elasticity of tax revenue is the ratio of the percentage change in tax revenue to a corresponding percentage change in personal income between two time periods. If a tax source grows more slowly than personal income it is "inelastic"; if it grows faster than personal income it is "elastic".

For a given tax rate and tax base, progressive income taxes are the most responsive to income growth. That is, personal income tax revenue tends to grow at a faster rate than personal income as individuals move into higher income tax brackets as a result of economic growth or inflation. Property tax revenue tends to grow more slowly than personal income, while sales taxes, depending on the base, may grow at about the same rate as personal income. The more responsive a tax is to changes in personal income, the less stable it is. Thus, a decline in personal income will result in a correspondingly greater decline in tax revenue from a highly responsive tax (e.g., the personal income tax).

Business Cycle Approach

Another approach to evaluating the stability of a tax is to examine changes in revenue collections through economic cycles of expansion and contraction. John Mikesell has developed indices that measure the cyclical sensitivity of tax revenue through the business cycle.[5] He found that corporate profits, and hence corporate income taxes, are extremely sensitive to economic fluctuations. He notes that this sensitivity justifies the reluctance by state governments to rely heavily on the corporate income tax. The individual income tax is the next most sensitive to economic fluctuations, but not near the level that corporate income taxes are. Property taxes and sales and excise taxes appear the least sensitive to economic cycles. Certain components of the sales tax, however, such as construction activity and consumer and business durable goods, may make the sales tax base more sensitive to economic cycles than the results of Mikesell's study would indicate.[6] This is borne out by the fact that several states (such as California, Florida, New Mexico, and Texas) that rely heavily on sales taxes have had to raise tax rates in recent years.

Using the business cycle to analyze the adequacy or stability of revenue may be a more reliable method than using the income elasticity of tax revenue because it better accounts for economic reality than does simply looking at income trends. Even in a recession, personal income tends to rise because of pay increases for persons who remain at work and because of growing interest and rental income and transfer payments.[7] Individuals and businesses, however, alter their economic behavior in a recession, either by choice or of necessity. A delay in the purchase of "big ticket" consumer durable goods or capital equipment is one example of that changed behavior. Such changes in behavior may have a negative effect on tax collections that may be greater than would be expected from simply analyzing changes in personal income. Conversely, in an expansion, individuals and businesses may alter their behavior to an extent that tax collections may be greater than would be expected from changes in personal income.

ADDITIONAL CONSIDERATIONS ON PERSONAL INCOME TAXES

The changing composition of personal income can have a significant effect on personal income tax collections, especially during a recession. As noted above, even in a recession, personal income generally continues to rise. However, much of the growth may be in nontaxable or partially taxable components of personal income. These components include transfer payments consisting of social security, unemployment benefits, welfare benefits, and retirement benefits.[8] Depending on the magnitude of the growth in nontaxable or partially taxable components relative to fully taxable components of personal income, the income elasticity approach might provide misleading information about the growth in revenue from the personal income tax.

SOME POLICY IMPLICATIONS

With respect to planning budgets and developing expenditure policies, state and local governments may want a smooth and predictable growth in tax revenues that roughly corresponds to growth in personal income or to an anticipated rate of growth in expenditure levels.

A reliable revenue source or sources would also be desirable if the demand for state and local government services increases with income. The "taste" for public goods and services, however, may be more strongly related to other variables (such as population size and composition) and to distinct preferences within a state. For example, Texas, New Hampshire, and

Connecticut may be typified as states with modest preferences for government services.[9] These modest preferences may be discerned from the tax structure of each state. Texas has no individual or corporate income tax; New Hampshire relies heavily on local property taxes to fund governmental services; and Connecticut, until recently, had relied on sales and property taxes as the primary means of funding state and local government.*

TRENDS IN MONTANA TAX REVENUE

Table 1 shows trends since 1970 in major state and local tax revenue relative to personal income in Montana. Information on tax revenue is presented in tax collections per $100 of personal income. The analysis is less sophisticated than either the income elasticity approach or the business cycle approach and is presented for illustrative purposes only.

The table shows yearly changes in total, local, and state revenue. Although total tax revenue (state and local) in $100 of personal income fluctuates over the period, it generally grew at about the same rate as total personal income. Ignoring the large increases in personal income taxes and "other" taxes that occurred in 1972, total state and local revenue reached a peak in 1978 of $12.96 per $100 of personal income. Between 1978 and 1983, total state and local tax revenue grew more slowly than personal income and has fluctuated since then. In 1988, total tax revenue per $100 of personal income was identical to that of 1970 ($12.41).

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* Connecticut enacted a personal income tax in August 1991 in response to a fiscal crisis. The state enacted an income tax in 1971, but public pressure led to its repeal. A similar effort to repeal the 1991 enactment failed.

When viewed separately, however, state tax revenue and local tax revenue per $100 of personal income have shown divergent trends. Local tax revenue exceeded state tax revenue until 1973 but has been below state revenue since then. Between 1970 and 1989, local tax revenue fell by 23 percent while state tax revenue increased by 21 percent. A look at some of the underlying causes indicates that this divergence is not surprising.

Table 1: Montana State and Local Tax Revenue per $100 of Personal Income, 1970 to 1989

Fiscal Year	Total Tax	Local Tax	State Tax	Personal Income Tax	Corporate Income Tax	Severance Tax	Other
1989	$12.13	$5.10	$7.03	$2.56	$0.54	$0.82	$3.10
1988	$12.41	$5.24	$7.17	$2.44	$0.46	$1.13	$3.13
1987	$11.53	$5.37	$6.16	$2.03	$0.36	$1.06	$2.72
1986	$12.39	$5.61	$6.79	$1.89	$0.64	$1.43	$2.82
1985	$12.80	$5.62	$7.18	$2.03	$0.70	$1.69	$2.76
1984	$12.35	$5.49	$6.86	$2.00	$0.42	$1.70	$2.74
1983	$11.86	$5.54	$6.33	$1.87	$0.44	$1.69	$2.32
1982	$12.29	$5.55	$6.73	$1.83	$0.57	$1.90	$2.44
1981	$12.31	$5.70	$6.61	$2.07	$0.75	$1.41	$2.37
1980	$12.24	$5.46	$6.78	$2.10	$0.71	$1.47	$2.50
1979	$12.07	$5.24	$6.84	$2.41	$0.62	$0.92	$2.89
1978	$12.96	$6.12	$6.83	$2.50	$0.59	$0.90	$2.84
1977	$12.83	$5.95	$6.88	$2.46	$0.55	$0.96	$2.91
1976	$12.64	$6.06	$6.58	$2.31	$0.55	$0.74	$2.98
1975	$11.84	$5.82	$6.02	$2.29	$0.57	$0.38	$2.78
1974	$12.04	$5.90	$6.14	$2.21	$0.44	$0.27	$3.23
1973	$12.49	$6.34	$6.15	$2.53	$0.40	$0.17	$3.05
1972	$14.05	$7.06	$6.99	$2.61	$0.43	$0.17	$3.78
1971	$12.17	$6.64	$5.52	$1.72	$0.39	$0.21	$3.20
1970	$12.41	$6.63	$5.79	$1.75	$0.43	$0.21	$3.40

Note: Revenue in each fiscal year is divided by personal income in the calendar year that ended during it.

Sources: For state tax revenue, U.S. Bureau of the Census, State Government Finances (Washington, D.C.: U.S. Government Printing Office, various years).
For local tax revenue, U.S. Bureau of the Census, Government Finances: (year) (Washington D.C.: U.S. Government Printing Office, various years).
For personal income, U.S. Department of Commerce, Regional Economic Information System, reported by Montana Office of the Legislative Fiscal Analyst, Appropriations Report: 1993 Biennium, Vol. 1 (Helena: 1991).

Local Tax Revenue

In a situation with a constant tax base and with constant tax rates, property tax revenue typically grows more slowly than personal income. Property taxes in Montana have historically accounted for over 95 percent of all local tax revenue, thus robust growth in local tax revenue in the state would not be expected. The Montana Legislature has from time to time reduced the statutory tax rates applied to most taxable property within the state or has provided property tax exemptions (e.g., business inventories). Voter approval of Initiative Measure No. 105 in 1986 has limited local governments' ability to increase property tax revenue. Finally, economic events beyond the control of the state, such as the precipitous decline in petroleum prices in the last half of the 1980s, have contributed to the decline in the property tax base statewide.[*]

State Tax Revenue

The growth in state tax revenue relative to personal income (except tax revenue from "other" sources[**]) has been much stronger than at the local level. In collections per $100 of personal income, personal income taxes were 46 percent higher in 1989 than they were in 1970, corporation income taxes were 25 percent higher, and severance taxes were 290 percent higher. Tax revenue from "other" sources was about 9 percent lower in 1989 than in 1970.

Personal Income Taxes: The growth in state tax revenue has not traced a smooth upward line, with economic forces and legislative actions affecting the trends. Although the current personal income tax rates have been in effect since 1969, other factors have contributed to the rise and fall of personal income tax collections per $100 of personal income. In 1971, voters validated a 40 percent surtax on personal income in lieu of a sales tax. In 1973, the surtax was reduced to 10 percent and remained in effect until 1981, when it was repealed. On November 4, 1980, Montana voters approved Initiative Measure No. 86 to index personal income taxes to inflation. The relation of personal income tax collections to personal income in the 1980s has also been affected by major changes in federal income tax law in 1981 (Economic Recovery Tax Act), 1982 (Tax Equity and Fiscal Responsibility Act), and 1986 (Tax Reform Act); by economic recession and slow recovery; and by the imposition in Montana of a 10 percent income surtax for tax years 1987 through 1989 and a 5 percent education surtax for tax year 1990.

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[*] Legislative enactments since 1989 that have had a significant impact on the property tax base and on property taxation (e.g., personal property tax reductions, the flat tax on energy production, and changes in school funding) are not reflected in Table 1.

[**] "Other" sources of tax revenue include excise taxes, license taxes, statewide property taxes, and inheritance and gift taxes.

Corporate Income Taxes: Two distinct trends in corporate income taxation in relation to personal income may be observed. Between 1970 and 1981, corporation tax collections per $100 of personal income increased from $0.43 to $0.75 in an almost continuous upward trend. Much of the consistent growth pattern may be attributable to energy and mineral development as well as to expansion in the wood products industry. Between 1981 and 1989 corporation income tax collections have exhibited the volatility normally associated with this tax. The economic recessions of 1980 and 1982, the ups and downs of the natural resource industries, and changes in federal corporate income tax law all contributed to the swings in corporation income taxes both in absolute and in relative terms.

Severance Taxes: Between 1970 and 1982, collections from severance taxes on oil, natural gas, and coal showed the strongest growth of any tax collections in relation to personal income, increasing from $0.21 per hundred dollars of personal income in 1970 to $1.90 in 1982.* Severance taxes leveled off at approximately $1.69 for the next 3 years before falling steadily to $0.82 by 1989. Lower energy prices and declining production accounted for much of the decrease, while reductions in severance tax rates accounted for the rest.

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* Total severance tax collections reached an all-time high of $150.6 million in 1985.

Other Taxes: The trend in "other" sources of tax revenue has exhibited an erratic pattern since 1970. In 1989, tax revenue per $100 of personal income from these sources was about 9 percent lower than it was in 1970. Because of the diversity of components that are included in other sources of tax revenue, no analysis of this tax source is presented at this time.

III. EQUITY

A second criterion in evaluating a "good" tax system is equity. The equity criterion involves the policy question of how tax burdens should be apportioned among individuals within the state.

There are two concepts associated with the equity criterion: the benefits-received principle and the ability-to-pay principle.* The benefits-received principle states that those who enjoy the benefits of goods and services provided by government should bear the burden of taxation in proportion to the amount of benefits received. As the measure of equity, this principle links the expenditure and revenue sides of the budget and also links tax burdens with benefits derived from government. The benefits-received principle is a theoretical concept that has limited applicability in the formulation of general tax policy. The principle is usually invoked when identifying certain groups of taxpayers who benefit from certain governmental services but who should not be recipients of a taxpayer subsidy.[10]

The alternative concept is the ability-to-pay principle. Under this principle, the amount of taxes or level of tax burden should be related to an individual's ability to pay based on economic well-being. Taxation under the ability-to-pay principle implies both horizontal and vertical equity. Horizontal equity is rooted in the principle of equal treatment under the law.[11] That is, persons of roughly equal economic capacity should pay the same amount in taxes. The related concept of vertical equity implies that persons with greater economic capacity should pay more taxes. Vertical equity can be measured in terms of whether the tax is progressive, proportional, or regressive according to whether payments rise, are constant, or fall as a proportion of income as income rises.

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* A more detailed discussion of the benefits-received and ability-to-pay principles is found in Chapter One, pp. 7-10.

MEASURES OF TAX BURDEN

Vertical equity may be analyzed in terms of the incidence or burden of a tax. Tax burden relates to the reduction in family income or purchasing power caused by paying taxes. Tax burden studies attempt to determine the distribution of taxes, both direct and indirect, according to income class or group. The tax burden is measured by the percentage of family or household income that is devoted to taxes. That percentage figure is referred to as the effective tax rate. Tax burden analyses employ a variety of assumptions about tax shifting and incidence, allocation of taxes by income group or class, and the appropriate household income base.*

The final incidence of business taxes, for example, is an important consideration in tax burden studies. Businesses do not pay taxes in the economic sense; that is, business taxes are ultimately paid by individuals as indirect taxes. Business taxes may be shifted forward to consumers in the form of higher prices, or such taxes may be shifted backward to workers in the form of lower wages or to stockholders in the form of lower dividends. There is no general agreement on the direction or magnitude of tax shifting by business. Thus, the allocation of business taxes to individuals often depends on the judgment of the analyst.

Among recent studies, at least two have provided estimates of state and local tax burdens. One is a study conducted by the Tax Foundation (TF) in

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* A discussion of the models used in tax burden studies is beyond the scope of this report. See Donald Phares, Who Pays State and Local Taxes, (Cambridge, Mass.: Oelgeschlager, Gunn and Hain, Publishers, Inc., 1980) for a discussion of the historical development of tax burden studies and an analysis of the models used.

1989.[12] The purpose of the TF study was to provide a detailed nationwide analysis of the distributional impact of federal, state, and local taxes. The primary data source for the study was the Bureau of Labor Statistics' Consumer Expenditure Survey (CES) for 1985-86. This survey provides comprehensive data on family income and consumption patterns and served as the basis for allocating tax burdens. Other data sources included Internal Revenue Service income statistics (1987-88) and U.S. Department of Commerce national income and product account data to estimate federal, state, and local government tax burdens by income class.

Table 2 summarizes the results of the TF study for the estimated nationwide tax burden, by income class, of state and local taxes. Family income corresponds to the "consumer unit" in the CES and represents all households, irrespective of specific household characteristics.

Table 2: State and Local Tax Burden in the U.S. as a Percent of Family Income, 1986

Income Class	Less than $10,000	$10,000 to $14,999	$20,000 to $29,999	$30,000 to $39,999	$50,000 to $59,999	$70,000 to $89,999	$90,000 and over
Personal Income Taxes	0.78%	1.11%	1.93%	2.26%	2.40%	2.40%	2.18%
Corporate Income Taxes	0.96%	0.60%	0.48%	0.41%	0.43%	.50%	1.52%
Property Taxes	5.58%	3.59%	2.84%	2.50%	2.52%	2.81%	3.76%
Sales Taxes	6.06%	3.36%	2.55%	2.26%	2.09%	1.83%	1.42%
Excise Taxes	3.90%	2.24%	1.57%	1.34%	1.10%	0.90%	0.65%
Total	17.28%	10.90%	9.37%	8.77%	8.54%	8.44%	9.53%
Other taxes and nontaxes	8.52%	4.93%	3.91%	3.52%	3.32%	3.02%	4.14%
Total taxes and nontaxes	25.80%	15.83%	13.28%	12.29%	11.86%	11.46%	13.67%

Note: This table does not show data for $15,000-$19,999, $40,000-$49,999, or $60,000-$69,999 income classes.

Source: Tax Foundation

The other study was conducted by the Citizens for Tax Justice (CTJ).[13] The primary purpose of the CTJ study was to estimate the impact, by state, of every major tax levied at the state and local level. Table 3 shows nationwide estimates of state and local tax burdens in 1991. Tax burden information is shown for families of four by average income for each income quintile. (Each quintile represents 20 percent of all families.)

Table 3: State and Local Taxes in the U.S. as Share of Income for Family of Four, 1991

Family Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Next 1%
Average Income	$12,700	$26,800	$39,100	$54,000	$82,000	$184,400	$875,200
Personal Income Taxes	0.7%	2.0%	2.6%	3.0%	3.5%	4.1%	4.6%
Corporate Income Taxes	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%	0.4%
Property Taxes	5.4%	3.7%	3.2%	2.9%	2.7%	2.3%	1.3%
Sales Taxes	5.7%	4.0%	3.3%	2.9%	2.4%	1.8%	1.2%
Excise Taxes	1.9%	1.1%	0.8%	0.7%	0.5%	0.3%	0.1%
Total Taxes	13.8%	10.9%	10.0%	9.5%	9.2%	8.7%	7.6%
Federal Offset Deduction	0.0%	-0.2%	-0.4%	-1.1%	-1.6%	-1.6%	-1.6%
Total After Offset	13.8%	10.7%	9.5%	8.4%	7.7%	6.9%	6.0%

Source: Replicated From Citizens for Tax Justice

The primary data sources used for the CTJ study include IRS statistics of income computer files for 1988 (income for 1991 was extrapolated from 1988 data), CES data, U.S. Department of Commerce personal consumption data, Bureau of the Census housing statistics and other sources that report property values, and information provided by state and local governments. A variety of sources were used to obtain information on state and local tax rates and for legislated tax changes for 1991.

The following discussion describes the tax burden reported by each study for the major state and local taxes. The discussion details some of the differences in methodology and assumptions.

Personal Income Taxes

Both studies show that personal income taxes are the most progressive element of the state and local tax structure. The CTJ study shows that the personal income tax is progressive throughout the income spectrum, while the TF study indicates that personal income taxes tend to be proportional for income classes $40,000-$49,000 (not shown in Table 2) and above. The effective tax rate for these income classes levels off at about 2.4 percent of personal income.

Corporate Income Taxes

According to the CTJ analysis, the tax burden of the corporation income tax is generally proportional for incomes up to $82,000 but slightly progressive after that. The CTJ study assumes that the corporate income tax is borne by owners of capital in the form of lower dividends.

The TF study, on the other hand, shows that the corporate income tax imposes a greater burden on low-income families than on middle-income families. The tax burden, however, tends to be progressive at the higher-income levels. The TF study assumes that half the corporate income tax is shifted forward to consumers as higher prices and half to owners of capital as lower dividends. Thus, the corporation income tax is regressive for lower-income families because consumption expenditures take a greater proportion of their family income, whereas the tax is progressive for upper-income families because dividend income is more concentrated in these income groups.

Sales and Excise Taxes

As is expected, both studies show that sale taxes and excise taxes are regressive throughout the income spectrum. Typically, the proportion of income spent on goods and services subject to these taxes falls as income rises. These studies show that the sales tax burden is about 4.3 (TF) to 4.8 (CTJ) times greater on families in the lowest-income class than on families in the highest-income class. The TF study shows that excise taxes impose a greater burden on families at every income level than is shown by the CTJ study.

Property Taxes

The analyses of property tax burdens exhibit somewhat divergent trends. The CTJ study shows that property taxes are regressive throughout the entire income scale, ranging from 5.4 percent of family income in the lowest quintile to 1.3 percent in the highest. According to the CTJ study, the tax burden on the lowest-income families is about four times greater than on the highest-income families. The CTJ study allocates the portion of business property taxes paid by local residents but does not allocate that portion exported out of state to absentee owners. As such, the study understates the property tax burden borne by higher-income families and overstates the regressivity of the property tax on a national basis.[14]

The TF study shows that the property tax is regressive at lower-income levels, proportional in the middle-income range, and progressive in the upper-income levels. The TF study accounts for the exported portion of the property tax that is excluded from the CTJ study. In addition, the higher-than-average burden on the highest-income class reflects the concentration of property owned by high-income families. Families in the lower-income classes spend a greater share of income on housing and thus experience a high property tax burden directly through property taxes or indirectly through higher rent.

Total Tax Burden

Each study shows slightly different results in the total tax burden of the major taxes described above (total effective tax rates on both tables). According to the CTJ study, the state and local tax structure is regressive throughout the income spectrum, while the TF study indicates that the tax structure is regressive until the highest-income level is reached. Both studies, however, show virtually identical disparity between the tax burden borne by the lowest-income class or group and by the highest-income class or group: families in the lowest-income class or group pay about 1.8 times more of their income for taxes than do families in the highest-income class or group.

The CTJ study adjusts the total state and local tax burden by subtracting from the total the itemized deductions for state and local income and property taxes that are allowed on federal income tax returns. The federal offset deduction represents tax savings at the federal level, as a share of income, for state and local taxes paid. Two factors affect the smaller offset deductions in the lower-income family groups. First, lower-income families typically do not itemize deductions for federal income tax purposes. If they do, the amount deducted is disproportionately less than for higher-income groups. Second, property tax burdens for lower-income families may be borne as indirect taxes in the form of higher rent and thus are not deductible for federal income tax purposes.

The federal offset adjustment increases the regressivity of state and local tax structures because the greatest tax savings occur in the higher-income groups. As a result, the total tax burden on the lowest-income family group rises from 1.8 to 2.3 times greater than that borne by the very highest-income group.

The TF study includes other taxes, nontaxes, and contributions for social insurance in its analysis of the burden for all taxes and charges imposed by state and local governments. Other taxes include estate and gift taxes (allocated entirely to the highest-income class), severance taxes, special business licenses, stock transfer taxes, and other miscellaneous taxes. Nontaxes include tuition and education charges, health and hospital charges, fines, rents and royalties, and other special assessments. Other taxes and nontaxes add significantly to the total tax burden for each income class, but they increase only slightly the overall regressivity of state and local taxes.

Although the results of the two studies exhibit some similar equity patterns by type of tax, they are not strictly comparable because of differences in purpose, methodology and assumptions, data sources, and year analyzed. Some differences have already been noted.

The purpose of the TF study was to assess the tax burden imposed not only by state and local governments but by the federal government as well. In terms of state and local tax burden, the TF study was more comprehensive than the CTJ study in that it attempted to allocate on a national basis all taxes and nontaxes imposed by state and local governments. This allocation specifically accounted for taxes exported (e.g., severance taxes and property taxes) to residents of other states. Conversely, the CTJ study reduced tax burdens by the estimated amount of taxes exported from a particular state and specifically excluded the impact of imported taxes on total burden. Thus, tax burden information for each state (and reflected in Table 3 as the average tax burden nationwide) only shows the impact of a state's tax policies on residents of the state.[15]

Another important difference between the two studies is that in determining tax burden by income class, the Tax Foundation used the broad concept of economic income. The Tax Foundation's definition of economic income consists of money income (including wage and salary income, interest and dividends, Social Security and pension income, self-employment income, public assistance, rental and other property income, unemployment compensation, and veterans' benefits) and nonmoney income (including undistributed corporate profits, employer-paid benefits, and imputed homeowner rent) less contributions for social insurance. According to the TF study, the computation of tax burdens based on income earned from productive services rather than actual dollar income would tend to overstate effective tax rates.[16]

Income for the CTJ study, on the other hand, is defined as federal adjusted gross income plus IRA deductions, tax-exempt interest, and rental, partnership, and small business corporation losses. The inclusion of these items provides a broad measure of income, but not so broad as that in the TF study.

Table 4: State and Local Taxes in Montana as Share of Income for Family of Four, 1991

Family Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Next 1%
Average Income	$8,900	$21,300	$31,700	$43,300	$66,600	$139,600	$708,200
Personal Income Taxes	0.4%	1.9%	2.4%	2.9%	3.5%	4.6%	5.0%
Corporate Income Taxes	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.4%
Property Taxes	3.3%	3.5%	3.5%	3.5%	3.1%	2.3%	1.4%
Sales Taxes	0.4%	0.3%	0.2%	0.2%	0.2%	0.1%	0.1%
Excise Taxes	2.9%	1.6%	1.3%	1.0%	0.8%	0.5%	0.1%
Total Taxes	7.1%	7.4%	7.4%	7.6%	7.6%	7.7%	7.0%
Federal Offset Deduction	0.0%	-0.2%	-0.3%	-0.6%	-1.7%	-2.0%	-1.7%
Total After Offset	7.1%	7.2%	7.2%	7.0%	5.9%	5.7%	5.3%

Source: Replicated From Citizens for Tax Justice

Montana Tax Burdens

Table 4 shows CTJ estimates of the tax burden on a family of four in Montana. The total tax burden in Montana before the federal offset deduction indicates a generally proportional state and local tax structure and a much lower overall tax burden than is the case nationwide. A progressive income tax and the absence of a sales tax account for much of the proportionality of Montana's tax burden. The effective tax rate of excise taxes in the state is slightly higher for every income group than it is nationwide, while the effective tax rate of property is close to the national average. The federal offset deduction makes the Montana tax structure slightly regressive in the highest-income quintile.

REVENUE ADEQUACY AND TAX EQUITY

The first pages of this chapter discussed concepts of elasticity and adequacy of tax revenue. The elasticity of tax revenue is the measure of the growth in revenue relative to growth in the economy, usually in terms of personal income growth. An elastic tax tends to grow faster than personal income, while an inelastic tax tends to increase more slowly than personal income. Although revenue adequacy and tax equity are separate policy issues, they are linked.[17] Property taxes and sales taxes (typically regressive taxes) tend to grow more slowly than personal income. Tax policies that reduce the regressivity of the tax structure are likely to lead to enhanced revenue growth.

IV. ECONOMIC NEUTRALITY

Economic neutrality is a third criterion for evaluating a "good" tax structure. Under normal conditions, competitive markets provide an efficient allocation of scarce resources. Economic efficiency in competitive markets is distorted if taxation policies unintentionally affect business decisions on price and output, consumer decisions on consumption patterns, or individual decisions on whether or not to work.[18] A specific sales or excise tax has the effect of raising the price of the product taxed. As a result, consumers will tend to purchase less of the taxed item and more of an untaxed item. For example, a selective excise tax on soda pop may cause consumers to purchase less soda pop and more of untaxed beverages. If that happens, the tax is economically inefficient because it alters economic choices.

The same analysis may be applied to a general sales tax. For example, a sales tax that exempts services favors consumers with preferences for services. As a result, there may be a shift from consumer goods to consumer services. Furthermore, spending patterns differ by family preferences within income groups so that a sales tax that exempts services imposes differential tax burdens among families with equal tax-bearing capacity[19], thus violating the principle of horizontal equity.

A personal income tax structure characterized by relatively high marginal tax rates may discourage individuals from working and encourage more leisure. Similarly, relatively high rates of taxation on the wealth of businesses may discourage capital accumulation or may encourage a business to relocate to a state where tax policies are perceived as more favorable. On the other hand, economic neutrality is enhanced if competing firms face the same effective tax rates measured against a common base.[20]

A tax structure that is competitive with other states is a criterion often considered in relation to economic neutrality. A state's tax structure is often equated with the "business climate" of the state. Proponents of economic development often compare the "pro-business" tax policies of surrounding states and use the comparison as justification for changing the state's tax policy or for obtaining a tax concession.

Studies analyzing the effects of business taxation have generally concluded that differences in state tax levels and tax incentives have little or no impact on a firm's location decisions.[21] In a recent report on taxation and expenditure policies in Montana[22], Beattie and Young reiterate this point by noting that until recently, most economic studies showed that state and local taxes were relatively insignificant factors in business location decisions. They point out, however, that more recent research may suggest otherwise. They describe a study by Benson and Johnson[23] that focuses on the measurement of relative tax rates among states. According to this study, existing differentials in tax rates between states are not so great as to cause widespread changes in location. Changes in location would occur when tax policies in one state are significantly altered relative to other states. Benson and Johnson point out, however, that the general immobility of business property precludes an immediate response to such changes in tax policy.

Obviously, many factors other than tax policy affect economic activity and business location decisions. Labor costs and other factor inputs, geography, access to markets, regulatory policies, "quality of life", and general economic conditions may all be relatively more important than tax considerations in business location decisions. In addition, companies with a major capital commitment to a state may prefer higher taxes if those taxes enhance the infrastructure within the state and increase the level of public services.

Regardless of the evidence of whether tax policies relating to business influence business decisions, state legislatures often appear eager to grant concessions. Ideally, states should develop some procedure to measure the effectiveness of tax concessions as an economic development tool. Until there is some mechanism to do this, business tax policy may be influenced more by demagogy and misinformation than cold hard facts (or cash).

V. SIMPLICITY OF COMPLIANCE AND ADMINISTRATION

Few would disagree that a tax system should be easy for taxpayers to understand and for government to administer. Beyond that, simplicity is neither easily defined nor easily measured. A tax that was "simple" in the sense of being easy to determine may conflict with other tax policy goals.

For example, a head tax may be the easiest tax to comply with and to administer. However, a head tax would be unrelated to a taxpayer's ability to pay and would not provide adequate revenue growth. Similarly, a gross receipts tax would be simpler to calculate and easier to administer than a net income tax, but it would conflict with horizontal equity.

Many states, including Montana, conform their personal income taxes and corporation taxes to federal income tax laws. Although federal income tax laws are extremely complex, conformity at the state level: (1) makes a state tax return easier to complete; (2) requires only one set of books; (3) eliminates the need for separate determinations of factual and legal questions; and (4) reduces the costs of administration.[24] Total conformity with federal taxes may further enhance simplicity but would severely limit flexibility in implementing state tax policy objectives.

There is an inherent complexity in determining taxable income for corporations that operate in more than one state. A state can only tax corporate income that is attributable to the state. State tax administrators must be able to determine the amount of a corporation's federal income that is taxable to the state.

The property tax is probably the most difficult tax to administer and to understand. As such, it is not surprising that the annual survey conducted by the nationwide Advisory Commission on Intergovernmental Relations has consistently found that the local property tax is viewed as the most unfair tax. Property taxes are frequently the target of taxpayer protests.

There are many reasons that the property tax is perceived as unfair. Perhaps the most significant is the apparent capriciousness of assessed values. Taxpayers become upset when they discover that their property is valued higher than their neighbors. Whether the difference is justified or not, the fact of the difference leads to an inherent mistrust of the property tax.

In Montana, the property tax classification system adds to the complexity, confusion, and mistrust of the tax. During the June 1989 Special Session and the 52nd Legislative Session, the Montana Legislature simplified the property tax structure by reducing from 20 to 12 the total number of property classes. Similar reductions have occurred in the past. In 1978, there were 20 different property classes; in 1983, there were 12 property classes; in 1985, sixteen; and in 1987, twenty. These vacillations cause taxpayers to speculate about the Legislature's commitment to tax fairness and simplicity.

VI. CONCLUSION

There are many criteria that may be used to evaluate a tax system. This chapter has highlighted a few of the commonly considered criteria of a "good" tax system: adequacy and stability of tax revenue, equity, economic neutrality (or efficiency) and tax competitiveness, and simplicity.

None of desirable features of a tax system can be fully realized in any practical sense. Prayers at the altar of tax equity or the altar of tax competitiveness may often go unanswered. Their imperfect achievement can only be obtained through tradeoffs in the political system.

Among citizens and policymakers in the United States, it is probably true that tax fairness may be the most important goal for any tax system. However, the concept of tax equity involves value judgments. The diversity in state and local tax structures, including policy preferences for one particular tax over another, indicates that no consensus has yet been agreed upon in determining the most equitable tax system. In addition, social and other policy goals figure into the calculus of any state and local tax structure. The question for policymakers is how to strike a balance between competing goals.

These issues will not be resolved by any comprehensive study of the state's tax system. The most a study can achieve is the development of some level of common understanding from which the debate may proceed.

ENDNOTES

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16. Tax Foundation, Tax Burden by Income Class: 1986-1987, p. 14.

17. Donald Phares, Who Pays State and Local Taxes, (Cambridge, Mass.: Oelgeschlager, Gunn and Hain, Publishers, Inc., 1980), p. 173.

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21. See, for example, Larry Finch, Taxes and Economic Development: A Literature Search with Policy Considerations, (Helena: Montana Department of Revenue, June 1985) for a detailed examination of studies addressing the effect of taxes on business activity.

22. Bruce R. Beattie and Douglas J. Young, Montana Taxation and Expenditure: Issues and Options, (Bozeman, Montana: Montana State University, July 1988).

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CHAPTER THREE

PUBLIC FORUM ON TAXATION

On May 14, 1992, the Revenue Oversight Committee held a public forum on Montana's tax structure. The purpose of the forum was to solicit comment from persons knowledgeable about Montana's tax structure on criteria that the Montana Legislature should consider in determining a "good" tax system, a "good" tax reform proposal, or a "good" tax bill. The forum was a followup to a report (Chapter Two) presented to the Committee that described four broad criteria for judging a "good" tax system: revenue adequacy, equity, economic efficiency, and simplicity. Participants were asked to discuss the issue of tax reform within the context of these criteria. Nine panelists presented their views on the relative importance of each criterion and on tax reform in general. Following the presentations, Committee members and panelists engaged in a roundtable discussion.

Each participant provided written material as well as an oral presentation. The following narrative is a summary of the participants comments and written testimony. A more comprehensive summary of the oral presentations, the written material, and a summary of the roundtable discussion are available in the Revenue Oversight Committee minutes of May 14, 1992.

Stan Nicholson, a semiretired economist from Seeley Lake, described the fiscal crisis facing Montana. He noted that Montana has a significant and growing structural deficit. According to Mr. Nicholson, this fiscal crisis was caused by "nearly stagnant funding of state and local public services" resulting "from an economy and tax revenues that have failed to grow sufficiently". He said that the state has run out of "band-aid" solutions typified in the January 1992 Special Session and that long-term tax reform is needed.

He said that the single most important challenge is to improve the revenue productivity of Montana's tax system. That goal can be achieved in the long run only through a growing economy. Any tax reform implemented to enhance revenue productivity must include provisions that maintain, at a minimum, the nearly proportional tax burden faced by Montana citizens, that improve the efficiency of the tax system with respect to business taxes, and that simplify the property tax structure.

Mr. Nicholson concluded that the best way to achieve significant tax reform is through community education. Citizen approval of any tax reform package is essential.

Ray Young, an accountant from Great Falls and chairman of a local tax study group, said that the Montana Legislature must initiate "thoughtful tax reform" before citizen initiatives remove tax reform from the legislative process. He said that prolonged studies of the tax system would unduly delay tax reform. Sufficient information is currently available for legislators to make intelligent decisions on tax reform.

He emphasized that while property taxes are the largest source of revenue in the state, they are the least fair form of taxation. Montana should consider all tax sources, including a sales tax, to ensure an equitable and efficient tax system. The negative aspects of one tax may be offset by the positive features of another.

Wes Higgins of Kalispell, chairman of a petition drive for a state constitutional amendment to limit government spending, said that the problem is not a lack of revenue, but too much spending by state and local government. Real reform must begin with spending limitations. He described Montana taxes as too high and unfair.

Mr. Higgins said that results of a survey conducted by Citizens for CI-65[*] showed that taxpayers have lost confidence in their elected officials and that confidence will not be regained until officials become fiscally responsible and accountable. Taxpayers would support a sales tax and increases in the personal income tax if there were proportionate reductions in property taxes.

Three panelists agreed that the ability to pay (typified by a progressive tax system) is the most important element of a good tax system and that a sales tax is not the solution for Montana's fiscal problems. George Paul, Executive Director of the Montana Farmers Union, concluded that tax cuts targeted for business have not attracted new industry to the state or encouraged existing businesses to expand. He agreed with Mr. Nicholson that citizen involvement in tax reform is critical.

Don Judge, Executive Secretary of the Montana AFL-CIO, added that the tax cuts for business have shifted the tax burden to individuals. He advocated reinstating a limited business inventory property tax and reimposing net and gross proceeds taxes on oil, natural gas, and coal production in lieu of the current flat taxes. These measures, coupled with a progressive income tax, would provide revenue balance and stability and would reduce the need for short-term solutions.

Ann Prunuske, Executive Director of Montana Alliance for Progressive Policy, emphasized that ability to pay is the most important criterion in evaluating a tax system. Violation of this criterion can lead to taxpayer revolt as evidenced by voter approval of the property tax freeze and by retiree opposition to income taxes on pensions. Reducing the regressivity of property taxes (such as revising the property tax circuit breaker or expanding the income tax credit for property taxes paid by low-income families and by senior citizens) would enhance the overall progressivity of Montana's state and local tax system.

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[*] The proposed Constitutional Initiative No. 65 would have imposed limits on governmental spending and taxation. The initiative did not qualify for the November 3, 1992, general election.

Mark Partridge, Professor of Economics at the University of Montana, said that empirical studies show that tax policies have no clear relationship to economic development within a state. He pointed out that conflicting results of economic studies on the importance of tax policies on economic growth are due to flawed methodologies that fail to account for governmental expenditure patterns. He said that more recent studies show that little association can be found between economic activity within a state and the tax policies of that state. In particular, low tax levels have only a small positive impact on economic growth because of the loss or reduction of beneficial government programs. On the other hand, governmental programs, such as improvements to infrastructure and education, may offset the increase in taxes used to fund them.

Mr. Partridge concluded that a major revision in the tax code would not necessarily turn Montana into an economic "juggernaut". Other factors, such as access to markets, may be more important to a state's economic strength. He pointed out that Montana is geographically isolated. As a result, "transportation costs are high and the size of the product market within Montana or in nearby states is very small".

Dan Bucks, former Deputy Director of the Montana Department of Revenue and current Executive Director of the Multistate Tax Commission, said that state tax systems are becoming obsolete as a result of the globalization of the economy. Most state tax systems are designed to tax the goods-producing sector more than the services sector of the economy. Services are increasingly more important in the nation's economy. Mr. Bucks said that in 1989, the nation, for the first time, spent more on services than on goods. If a sales tax were adopted in Montana, it should include services in the tax base.

Mr. Bucks observed that many of the arguments discussed at the forum, especially those dealing with the sales tax, have been expressed in the past. He said that Montana citizens and policymakers may have to refocus their thinking and explore other options of tax reform. In particular, he suggested that the state look into an income-based, value-added tax, similar to Michigan's single business tax, as one way of expanding the debate. A value-added tax is a single, flat-rate tax that is applied to all business activity regardless of ownership of the business. The value-added tax tends to be economically efficient because it taxes all factors of production the same. He cautioned that the tax is little understood and that little is known about how the tax would affect different economic sectors, particularly the agricultural sector.

Charles Walk, Executive Director of the Montana Newspaper Association, viewed the issue of tax reform from a different perspective. He described public sentiment about state tax policy as derived from letters to the editor submitted to newspapers around the state. He said that the vast majority of comments deal with the pros and cons of a sales tax. While the number of letters opposing a sales tax is greater than the number supporting one, the gap is narrowing. Opponents often express frustration that the issue is still being debated. Proponents express frustration that something must be done to get the state out of its fiscal crisis.

There was consensus that changes need to be made to Montana's tax structure, but there was little agreement on what those changes should be. If the sometimes heated exchanges that occurred during the roundtable discussion are any indication, the implementation of tax reform is going to be a difficult task, at best.

CHAPTER FOUR

ANALYSIS OF THE MONTANA PERSONAL INCOME TAX STRUCTURE

INTRODUCTION

The personal income tax is the single largest source of state tax revenue in Montana. Because of the importance of the personal income tax to the state's revenue structure, it has often been the object of tax reform efforts. During the last three regular legislative sessions, several proposals have been introduced to revise the way personal income is taxed. These proposals have included taxing income based on a percentage of federal liability, changing the tax base to federal taxable income, revising the rate structure, and limiting the deduction for federal taxes. These proposals have been introduced to enhance tax equity, to reduce administrative and compliance costs, to improve the state's business climate, and, only secondarily, to increase state tax revenue.

Often, these proposals are considered in the absence of a thorough knowledge of the existing personal income tax structure. This chapter analyzes the state's personal income tax structure. It describes the level of personal income taxes, evaluates the income tax base, provides a brief history of the tax, and analyzes the progressivity of the tax. When appropriate, comparisons are made with other states.

INCOME TAXES AS A SOURCE OF STATE REVENUE

The Territory of Hawaii first imposed a tax on individual and corporate income in 1901. Wisconsin adopted personal income taxes in 1911. By 1933, the tax was imposed in 22 states, including Montana. By 1969, broad-based personal income taxes were employed in 40 states and the District of Columbia. Connecticut enacted a personal income tax in August

1991 in response to a fiscal crisis. Before that enactment, Connecticut taxed only capital gains and dividend income. Two states, New Hampshire and Tennessee, limit taxation of personal income to interest and dividend income. Seven states, Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming, do not impose individual income taxes.

While the general sales tax is still the largest source of state revenue nationwide, the personal income tax has become increasingly important. According to the U.S. Bureau of the Census, the sales tax is the predominant source of revenue in 23 of 50 states and is the major source in 18 of the 39 states that impose both a sales tax and an income tax.[1] In fiscal year 1990, the sales tax (excluding selective sales and excise taxes) accounted for 33.2 percent of the approximately $300.5 billion of state tax collections.[2] The personal income tax is the primary source of revenue in 24 states and accounted for 32 percent of total state tax collections in 1990. In 1932, only 3.9 percent of state tax collections were attributable to the personal income tax, and only 0.4 percent of state tax collections were attributable to the sales tax.[3] The contribution of income taxes to state tax revenue was less than 15 percent in 1966, but that contribution has grown steadily since then, reaching an all-time high of 32.6 percent in 1988.[4]

MONTANA PERSONAL INCOME TAXES COMPARED WITH THOSE OF OTHER STATES

Reliance on the personal income tax varies substantially among the states. Table 1 shows the percentage of personal income taxes to total state tax revenue in Montana and 12 surrounding states.*

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* These states served as comparison states for the examination of Montana state employee compensation issues under the study directed by House Bill No. 786 (Ch. 660, L. 1989).

Table 1: Personal Income Tax Collections as a Share of Total State Tax Collections, 1990*

State	Income Tax Collections (Thousands of Dollars)	Income Tax as a Percent of Total
Arizona	$1,063,804	24.3%
Colorado	1,341,695	43.7%
Idaho	403,461	35.4%
Minnesota	2,876,636	42.2%
Montana	279,643	32.6%
Nevada	-0-	-0-
New Mexico	360,971	17.9%
North Dakota	105,687	15.6%
Oregon	1,826,646	65.6%
South Dakota	-0-	-0-
Utah	646,830	36.6%
Washington	-0-	-0-
Wyoming	-0-	-0-
United States	96,076,243	32.0%

Source: U.S. Bureau of the Census, State Government Tax Collections: 1990.

Four of the seven states without a personal income tax are within the comparison region. Oregon, which relies more heavily on personal income taxes than any state in the nation, is also in the comparison region. The reliance on personal income taxes in Montana is about the same as in the nation as a whole. Arizona, New Mexico, and North Dakota are much less reliant on this tax than Montana, while Colorado, Minnesota, and Oregon are much more reliant. Idaho and Utah are only slightly more reliant on personal income taxes than is Montana. Of the major mineral-producing states in the region (Montana, Nevada, New Mexico, North Dakota, and Wyoming), Montana is the most reliant on the personal income tax.

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* Using 1990 as a comparison year may be somewhat misleading. In that year, the U.S. Bureau of the Census included for the first time property tax revenue from the countywide levies for schools as state tax revenue (and may have counted it as local tax revenue as well).

Total tax collections do not provide a meaningful comparison between states because of differences in population and economic capacity (as measured by personal income). Interstate tax comparisons can be made by using per capita collections or by using collections relative to personal income of the state. Table 2 shows income tax revenue per capita and per thousand dollars of personal income in fiscal year 1990. Montana ranked sixth in per capita income tax collections among the nine comparison states with an individual income tax and ranked 26th in the nation as a whole.[5]

Table 2: **Comparison of Income Tax Revenue Per Capita and Per Thousand Dollars of Personal Income, 1990**

State	Per Capita Tax Revenue	Rank	Per $1,000 Pers. Income	Rank
Arizona	$290.26	7	$19.11	7
Colorado	407.31	3	23.01	6
Idaho	400.26	4	28.51	4
Minnesota	657.52	1	37.20	2
Montana	**349.99**	**6**	**24.22**	**5**
Nevada	NA	NA	NA	NA
New Mexico	238.26	8	17.84	8
North Dakota	165.39	9	11.68	9
Oregon	642.73	2	40.23	1
South Dakota	NA	NA	NA	NA
Utah	375.41	5	29.02	3
Washington	NA	NA	NA	NA
Wyoming	NA	NA	NA	NA
United States	387.24	NA	21.95	NA

Note: NA means not applicable.

Sources: For per capita income tax revenue, U.S. Bureau of the Census, State Government Finances, (Washington, D.C.: U.S. Government Printing Office, August 1991), p. 44.
For personal income, U.S. Department of Commerce, Survey of Current Business, (Washington, D.C.: U.S. Government Printing Office, August, 1991), Table 3.

Per capita income tax collections as a percent of the United States average were 169.8 percent in Minnesota and 166 percent in Oregon (ranked first and second among the comparison states) and 61.5 percent in New Mexico and 42.7 percent in North Dakota (ranked eighth and ninth among the comparison states). Per capita income tax collections in Montana were 90 percent of the U.S. average.

Measuring taxes relative to personal income provides a more accurate estimate of a state's relative tax burden than do per capita levels. For example, tax collections per thousand dollars of personal income indicate the relationship between tax levels and economic activity within the state. Using this measure, the rankings of the comparison states change only slightly. The largest change occurs in Colorado, which drops from third using the per capita measure to sixth using the income measure. Colorado, a relatively high-income state, devotes a smaller fraction of its personal income to personal income taxes than would be indicated by per capita collections, while Montana, a relatively low-income state, devotes a larger share of personal income to personal income taxes. Income tax collections per thousand dollars of personal income in Montana are about 10 percent above the national average.*

DETERMINATION OF THE INCOME TAX BASE

Many states, including Montana, conform their personal income taxes to federal income tax laws. Although federal income tax laws are extremely complex, conformity at the state level: (1) makes a state tax return easier to complete; (2) requires only one set of books; (3) eliminates the need for separate determinations of factual and legal questions; and (4) reduces the costs of administration and compliance.[6]

In Montana, the state's personal income tax base, including adjusted gross income, federal taxes paid, and many itemized deductions, is directly affected by the federal tax code. Conformity to federal income tax laws may restrict a state's control of its income tax base. For example, beginning after tax year 1990, federal law requires an individual whose adjusted gross income exceeds the applicable amount ($100,000 or $50,000 for a married person filing a separate return) to reduce itemized deductions by the lesser of 3 percent of the excess over the applicable amount or 80 percent of the amount of itemized deductions allowed.[7] This provision has been incorporated into the Montana individual income tax return and may result in increased revenue collections for the state.

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* These comparisons relate only to personal income taxes considered in isolation from other taxes levied by the states. A comprehensive comparison must include all major taxes used by the states.

In addition, the personal income tax base was significantly expanded by the federal Tax Reform Act of 1986. Limitations on IRA and Keogh retirement deductions and on deductible medical expenses, the phaseout of interest deductions, lower federal tax liability, etc., all contributed to the expansion of Montana's income tax base.

On the other hand, proposals before Congress could adversely impact Montana. Some of these proposals include partial exemption of or inflation indexing of capital gains and liberalized deductions for retirement accounts.[8] Federal tax policies designed to stimulate savings and investment at the national level may not promote economic development at the state level and could result in lost revenue to the state.

Federal income is used as the starting point for determining taxable income in most states.* In Montana, income from all sources except income specifically excluded by federal law is combined to arrive at total income. Sources of income include wages and salaries, net business income, the taxable portion of social security and retirement income, interest and dividend income, capital gains (or losses), rent income, royalty income, partnership income, etc. From total income, certain adjustments (deductions for IRA and Keogh plans, self-employment tax and health insurance payments, and alimony paid) are allowed to arrive at federal adjusted gross income. Montana adjusted gross income is derived from certain additions and reductions to federal adjusted gross income. Additions to income include interest on out-of-state government bonds, federal income tax refunds, etc. Reductions to income include interest exclusions for the elderly and for U.S. government obligations, exempt retirement income, etc. Adjusted gross income is further reduced by allowable deductions (standard or itemized) and by personal exemptions* to arrive at Montana state taxable income. State tax rates are applied to taxable income to determine tax liability. Tax liability may be reduced by allowable credits.

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* Five states (Alabama, Arkansas, Mississippi, New Jersey, and Pennsylvania) do not use federal income as a base for determining state income tax liability.

Table 3 compares tax rates and taxable income bracket amounts for those states within the comparison region that impose a personal income tax. The table shows considerable variability in tax rates and bracket amounts. North Dakota and Montana have the highest top marginal tax rate of any state in the region as well as in the nation. California has a top marginal tax rate of 11 percent on income over $400,000. The lowest bracket amount ranges from $1,000 in Idaho to $20,000 ($10,000 for single taxpayers) in Arizona, while the highest bracket amount ranges from $5,000 in Oregon to $300,000 ($150,000 for a single taxpayer) in Arizona. The number of income tax brackets also varies considerably among the states.

Table 3 also shows whether federal income taxes are deductible. Montana and North Dakota are the only states in the region that allow full deductibility of federal income taxes. Oregon limits the deduction to a maximum of $3,000, while Utah limits the deduction to one-half of federal income tax paid. Previously, Arizona** and Utah allowed for full deductibility, while North Dakota allowed no deduction for federal income taxes.[9]

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* Some states (e.g., Oregon) allow income tax credits in lieu of personal exemptions.

** Arizona has significantly revised its income tax structure.

Table 3: State Individual Income Tax Rates as of June 1991

	Lowest Bracket Rate	To Taxable Income of	Highest Bracket Rate	To Taxable Income of	Number of Brackets	Federal Inc. Tax Deduct.
Arizona	3.8%	$20,000	7%	$300,000	5	No
Colorado	5% of federal taxable income				NA	No
Idaho	2%	1,000	8.2%	20,000	8	No
Minnesota	6%	19,910	8.5%	79,120	3	No
Montana	**2%**	**1,600**	**11%**	**57,600**	**10**	**Yes**
New Mexico	1.8%	5,200	8.5%	41,600	7	No
North Dakota	2.67%	3,000	12%	50,000	8	Yes
Oregon	5%	2,000	9%	5,000	3	Limited
Utah	2.55%	1,500	7.2%	7,500	6	Limited

Notes: Taxable income amounts listed for Minnesota and Utah apply to married taxpayers filing jointly. The taxable income amounts listed for Arizona apply to married taxpayers filing jointly and to head of household. Tax rates and taxable income brackets in New Mexico vary depending on the filing status of the taxpayer. Montana income brackets are indexed for inflation.

Source: Commerce Clearing House

Table 3 is presented for illustrative purposes only. By itself, the information contained in the table has limited value for making interstate tax comparisons because of differences in the tax base,* allowable deductions, the level of personal exemption deductions or credits, and the filing status of the taxpayer.

HISTORY OF THE MONTANA PERSONAL INCOME TAX**

In 1911, Wisconsin became the first state to enact a state personal income tax. The Wisconsin Tax Commission predicted that state taxation of income would "spread like wildfire".[10] However, between 1911 and 1929, only 10 states had imposed personal income taxes. The situation changed dramatically with the onset of the Great Depression. Between 1929 and 1938, 18 states imposed personal income taxes, while 24 states enacted sales taxes.[11]

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* All states within the comparison region use federal income as the tax base, but the actual starting point (e.g., federal gross income or federal taxable income) varies among the states.

** A chronology of changes to the Montana individual income law is shown in TAXBOOK, compiled by Terry W. Johnson, originator, Teresa O. Cohea, Mike Walsh, and James E. Standaert (Helena: Office of the Legislative Fiscal Analyst, updated February 4, 1992).

Like many states at the time, Montana relied heavily on property taxes for state revenue, but the depression increasingly caused the devaluation of property. A fiscal crisis was looming. In 1931, the Legislature happily followed Governor John Erickson's advice to drastically cut expenditures.[12] The Legislature also directed the State Board of Equalization to examine the state's tax system for basic fiscal policy and to make recommendations to the 23rd Legislature (Ch. 190, L. 1931).

The 23rd Legislature enacted a personal income tax law in 1933 (Ch. 181, L. 1933). To ensure that the new tax was constitutional, the Legislature referred a constitutional amendment allowing for the taxation of income to the people of Montana. In the original enactment, the Legislature established four income tax brackets ranging from a 1 percent marginal tax rate on the first $1,000 of taxable income to a 4 percent marginal tax rate on taxable income over $6,000. During the Extraordinary Session of 1933-34, the Legislature imposed a graduated surtax (Ch. 40, Ex. L. 1933). The surtax ranged from 0 percent on the first $2,000 of net income to 25 percent on net income in excess of $100,000. The surtax, held unconstitutional in the case of Mills v. State Board of Equalization, et al., was applied in tax year 1933 only.

The marginal tax rates and taxable income brackets established by the 23rd Legislature remained in effect until 1957. In that year, the top rate was increased to 5 percent of taxable income in excess of $7,000. The top rate was again increased to 7 percent in 1959 and to 7.9 percent in 1965. During an extraordinary session in 1967, the top marginal rate was increased to 10 percent on taxable income in excess of $25,000 (Ch. 5, Ex. L. 1967).

The number of tax brackets increased from six to eight. The Legislature also provided for a 5 percent reduction in tax liability (sort of a negative surtax). During an extraordinary session in 1969, the Legislature increased the top marginal rate to 11 percent on taxable income in excess of $35,000 (Ch. 10, Ex. L. 1969). The Legislature also repealed the 5 percent tax reduction and imposed a 10 percent surtax.

On November 2, 1971, voters approved a referendum (Ch. 9, Ex. L. June 1971) to impose a 40 percent surtax on personal income in lieu of a sales tax. In 1973, the surtax was reduced to 10 percent and remained in effect until 1981, when it was repealed. A 10 percent income surtax was reimposed for tax years 1987 through 1989, and a 5 percent education surtax (in lieu of a sales tax) was in effect for tax year 1990.

The nominal taxable income brackets and the marginal tax rates have not been changed since 1969. Under a graduated progressive income tax structure, inflation causes unlegislated increases in the real burden of the income tax (commonly referred to as "bracket creep"). One way to alleviate bracket creep is to index the taxable income bracket amounts to inflation. On November 4, 1980, Montana voters approved Initiative Measure No. 86 to index personal income taxes to inflation. Under the initiative, an inflation factor is applied to the income tax brackets contained in 15-30-103, MCA, personal exemptions ($800 per exemption) allowed in 15-30-112, MCA, the standard deduction (but not the percentage rate)[*] allowed in 15-30-122, MCA, and the minimum filing requirements (based on gross income) provided in 15-30-142, MCA. The inflation factor is determined for each tax year by dividing the Consumer Price Index (United States city average for all items) for June 1980 by the Consumer Price Index for June of the tax year. Income tax brackets are rounded to the nearest $100, while the personal exemption and the standard deduction amounts are rounded to the nearest $10.

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[*] The standard deduction is 20% of Montana adjusted gross income not to exceed $1,500 for a single taxpayer or $3,000 for married filing jointly or head of household.

The 1981 Legislature increased the maximum nominal standard deduction for a single taxpayer from $1,000 to $1,500 (Ch. 516, L. 1981) and the minimum filing requirement from $940 to $1,000 (Ch. 548, L. 1981).

Table 4 shows taxable income for each income tax bracket in nominal (i.e., statutory brackets) and inflation-adjusted amounts for tax year 1991. Under indexing, the lowest marginal tax rate (2 percent) is applied to taxable income up to $1,600, while the highest marginal tax rate (11 percent) is applied to taxable income in excess of $57,600.

Table 4: Montana 1991 Taxable Income Brackets Indexed for Inflation

Nominal Taxable Income ($)	1991 Indexed Taxable Income ($)	Income Tax Rates
0-1,000	0-1,600	2%
1,001-2,000	1,601-3,300	3%
2,001-4,000	3,301-6,600	4%
4,001-6,000	6,601-9,900	5%
6,001-8,000	9,901-13,200	6%
8,001-10,000	13,201-16,400	7%
10,001-14,000	16,401-23,000	8%
14,001-20,000	23,001-32,900	9%
20,001-35,000	32,901-57,600	10%
35,001+	57,601+	11%

Source: Montana Department of Revenue

Since 1980, the maximum amount in each bracket has increased by more than 60 percent. As a result, individuals face lower marginal tax rates than they otherwise would without indexing. For example, an individual with taxable income of $23,000 without indexing would face a 10 percent marginal tax rate; with indexing, the marginal tax rate is 8 percent. In addition, the indexation of personal exemptions and standard deduction makes the taxpayer's taxable income less than it would be without indexing.

For tax year 1991, the maximum standard deduction amount is $2,470 (or $4,940 if filing jointly or head of household) and each personal exemption is $1,320.

MONTANA INCOME TAX COLLECTIONS SINCE 1970

Table 5 shows personal income tax collections in Montana since fiscal year 1970 in current dollars and in constant 1990 dollars, using the price deflator for state and local government expenditures. The table also shows income tax collections per thousand dollars of personal income in current year dollars.

Since fiscal year 1970, personal income tax collections have grown at an average annual rate of 10.4 percent. During the same period, Montana's personal income grew by about 8.3 percent. The average annual growth rate in income tax collections was 15.4 percent between fiscal years 1970 and 1979 (11.3 percent for personal income) but has fallen to 6.39 percent since then (6 percent for personal income). The slow growth in tax collections occurred between fiscal years 1980 and 1987. The repeal of the 10 percent surtax, the indexation of personal income taxes, and economic recession all contributed to the slow growth in personal income taxes during this period. Further evidence of the slow growth of personal income taxes during this period is indicated by the decline in income tax collections per thousand dollars of personal income. Collections per thousand dollars of personal income fell from $24.13 in fiscal year 1979 to $18.94 in fiscal year 1986, indicating that personal income in Montana grew at a faster rate than collections.* After enactment of the federal Tax Reform Act of 1986 (and the reimposition of Montana income tax surcharges), income tax collections increased by about 13 percent per year between 1986 and 1990.

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* See Chapter Two for a discussion of the responsiveness of tax collections to changes in personal income.

Table 5: Montana Personal Income Tax Collections In Current and Inflation-Adjusted Dollars, Fiscal Years 1970-1990 (In Thousands of Dollars)

Fiscal Year	Current Dollars	Collections Per $1,000 of Income	Inflation-Adjusted Dollars
1990	$279,643	$24.22	$279,643
1989	265,540	25.69	277,932
1988	243,769	24.41	267,634
1987	194,677	20.31	223,823
1986	172,216	18.94	205,698
1985	181,057	20.29	222,658
1984	170,346	20.03	219,016
1983	151,800	18.70	204,865
1982	143,804	18.30	203,195
1981	146,036	20.75	220,930
1980	134,987	21.00	221,272
1979	141,421	24.13	257,179
1978	123,621	24.96	245,677
1977	111,861	24.62	239,122
1976	97,521	23.10	222,254
1975	88,599	22.91	215,474
1974	78,949	22.05	211,679
1973	77,066	25.31	228,290
1972	68,082	26.05	216,666
1971	42,328	17.21	142,743
1970	38,871	17.46	140,114

Source: U.S. Department of Commerce, U.S. Bureau of the Census and Bureau of Economic Analysis

In real terms (inflation-adjusted dollars), personal income tax collections grew by 3.52 percent per year between 1970 and 1990. The average growth rate between 1970 and 1979 was 6.98 percent per year, or slightly less than the inflation rate. Since 1979, the average growth rate in real terms has fallen to less than 1 percent per year. Since federal tax reform, however, the average growth rate has been about 8 percent per year, well above inflation.

DISTRIBUTION OF THE PERSONAL INCOME TAX BURDEN IN MONTANA

Most Montana wage earners, as shown in Table 6, pay at least some income tax. Much of the burden, however, is borne by middle- and upper-income households.* In 1990, the households earning more than $25,000, accounting for about 75 percent of the state's income, paid approximately 86 percent of the income tax. Similarly, households with income accounting for 50 percent of the state's income (households earning more than $40,000) paid 66 percent of the income tax, while those households earning more than $150,000, accounting for 10 percent of the state's income, paid 17 percent of the tax.

The distribution patterns portrayed in Table 6 are based on expanded income as reported by the Montana Department of Revenue. Expanded income represents all household income reported on the federal income tax return plus Montana additions to federal income (e.g., interest on other states' bonds and federal income tax refunds). It also includes capital gains exclusions, interest exclusions for the elderly, exempt retirement income, and other reductions in income allowed to arrive at Montana adjusted gross income.** Expanded income is an approximation of gross income and better reflects ability to pay than does adjusted gross income.

Table 6 also shows the effective tax rates (taxes owed before credits as a percentage of expanded income) for each expanded income bracket and provides a measure of the progressivity of the state income tax. The average tax burden rises from 0.6 percent of expanded income for households in the lowest-income bracket to 5.72 percent for households in the highest bracket, indicating a progressive income tax. Prior to the federal Tax Reform Act of 1986, the Montana personal income tax structure tended to be regressive for households earning more than $70,000.[13]

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* For the purposes of the discussion in this section, households include full-time Montana residents only.

** In 1990, these reductions to income resulted in tax savings of about $34 million.

Table 6: Distribution of Personal Income Tax Burden for Montana Residents by Expanded Income Group, 1990

Expanded Income Bracket (Thousands of dollars)	Number of Households	Expanded Income (Thousands of dollars)	Taxes Paid (Thousands of dollars)	Cumulative Income Share	Cumulative Share of Taxes Paid	Effective Tax Rate
0	4,650	0	0	0.0%	0.0%	0.0%
0-6	61,200	183,101	1,095	2.3%	0.4%	0.60%
6-8	19,050	132,745	1,242	4.0%	1.0%	0.94%
8-10	16,050	143,397	1,723	5.8%	1.7%	1.20%
10-12	17,574	193,448	2,241	8.2%	2.6%	1.16%
12-16	29,829	415,646	6,772	13.5%	5.3%	1.63%
16-20	24,270	437,515	7,678	19.0%	8.5%	1.76%
20-25	25,896	580,940	12,525	26.3%	13.6%	2.16%
25-30	21,576	589,834	14,533	33.7%	19.5%	2.46%
30-40	36,609	1,274,746	36,193	49.8%	34.2%	2.84%
40-50	24,492	1,095,283	34,488	63.6%	48.3%	3.15%
50-70	21,211	1,222,101	44,004	78.9%	66.2%	3.60%
70-100	7,152	583,912	23,858	86.3%	75.9%	4.09%
100-150	2,865	343,943	16,543	90.6%	82.7%	4.81%
150+	2,251	744,194	42,551	100.0%	100.0%	5.72%
Total	314,675	7,940,805	245,447			3.09%

Note: Totals may not add due to rounding.

Source: Montana Department of Revenue

Households in Montana have the choice between itemizing deductions or taking the standard deduction, whichever is larger. The standard deduction is 20 percent of adjusted gross income up to a maximum, in 1990, of $4,720 (for joint or head of household returns) or $2,360 (for other returns). Major itemized deductions include federal income taxes, home mortgage interest, property taxes, and charitable contributions. Table 7 shows the distribution of tax savings associated with these and other itemized deductions by expanded income group. Other itemized deductions include medical expenses (limited to 7.5 percent of Montana adjusted gross income), other taxes paid, other interest expenses (personal interest is no longer deductible), moving expenses, and other miscellaneous deductions. The largest tax savings results from the deductibility of federal income taxes, accounting for about 55 percent of total tax savings for households that itemize. In 1990, households earning more than $50,000 accounted for about 70 percent of the tax savings associated with this deduction.

Table 7: Tax Savings From Itemized Deductions by Expanded Income Bracket, 1990 (Thousands of Dollars)

Expanded Income Bracket	Federal Income Tax	Property Tax	Home Mortgage Interest	Contributions	Other	Total
$0-6	7	2	9	1	30	48
$6-8	44	6	24	6	63	143
$8-10	49	21	45	11	68	195
$10-12	93	67	97	41	206	505
$12-16	306	134	262	105	464	1,271
$16-20	724	232	576	262	753	2,546
$20-25	1,501	389	1,066	361	1,050	4,367
$25-30	2,382	525	1,574	396	1,118	5,995
$30-40	7,836	1,479	5,053	1,302	3,020	18,689
$40-50	9,358	1,551	5,198	1,411	2,698	20,216
$50-70	13,975	1,932	6,515	1,968	2,917	27,307
$70-100	8,640	877	2,774	1,170	1,533	14,994
$100-150	6,621	496	1,361	848	849	10,174
$150+	21,417	603	1,644	1,855	1,553	27,073
Total	72,953	8,315	26,198	9,736	16,321	133,523

Note: Totals may not add due to rounding.

Source: Montana Department of Revenue

The next largest tax savings comes from home mortgage interest deductions, accounting for about 20 percent of the total itemized savings. Households earning more than $50,000 accounted for about 47 percent of the tax savings associated with this deduction. Taken together, deductions for federal income taxes, home mortgage interest, property taxes, and contributions account for about 88 percent of tax savings from itemized deductions, with 62 percent of the tax savings going to households earning more than $50,000.

SUMMARY

The personal income tax is the most important component of Montana's revenue structure. Montana, like many other states, imposed the personal income tax in response to the fiscal crisis of the Great Depression. Most of the major changes to Montana's personal income tax laws occurred during special sessions.

Montana's personal income tax structure is similar to that of many states in the computation of taxable income. While the state's income tax structure was somewhat regressive in higher-income brackets prior to federal tax reform, it now appears to be fairly progressive throughout the income scale. On the average, state income tax collections have grown at a faster rate than personal income, although indexing has reduced the disparity.* Even though Montana has one of the highest top marginal tax rates in the nation, personal income taxes do not take a disproportionate share of personal income when compared to the rest of the nation.

Changes to the existing personal income tax structure could be accomplished in a variety of ways, from tinkering with the existing structure to a major overhaul. Repeal of or limits to indexing and federal deductibility and revisions to the tax rates are examples of tinkering with the existing system. A tax structure based on federal taxable income or based on federal liability is an example of a major overhaul. In changing the existing structure, decisionmakers will have to choose among a variety of priorities, including the revenue needs of the state, the distributional effects of the tax, the economic effects, and simplicity.

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* See the Montana Department of Revenue report (*Individual Income Tax Liability by Taxpayer Income Class*) in the appendix of this report for more information on the indexation of individual income taxes.

ENDNOTES

1. U.S. Bureau of the Census, State Government Tax Collections: 1990, (Washington, D.C.: U.S. Government Printing Office, August 1991), p. vi.

2. Ibid., p. v.

3. Tax Foundation, Inc., Facts and Figures on Government Finance--1991 Edition, (Baltimore: The Johns Hopkins University Press, 1991), p. 241.

4. Ibid.

5. U.S. Bureau of the Census, State Government Tax Collections: 1990, p. 44.

6. Richard D. Pomp, "Simplicity and Complexity of a State Tax System," in Reforming State Tax Systems, Steven D. Gold (ed.), (Denver: National Conference of State Legislatures, 1986), p. 122.

7. Title 26, section 68, U.S.C.

8. "Tax Report," Wall Street Journal, February 19, 1992, p. 1.

9. Tax Foundation, Inc., Facts and Figures on Government Finance: 1991 Edition, Table E23.

10. John Shannon, "State Revenue Diversification--The Search for Balance," in The Quest for Balance in State-Local Revenue Structures, Frederick D. Stocker (ed.), (Cambridge, Mass: Lincoln Institute of Land Policy, 1987), p. 11.

11. Ibid., p. 12.

12. Michael P. Malone and Richard B. Roeder, Montana: A History of Two Centuries, (Seattle: University of Washington Press, 1988), p. 228.

13. Montana Department of Revenue, Your Taxes in Montana, Report No. 1, "The Present System: Is It Fair? Is It Balanced?," (Helena: Montana Department of Revenue, September 12, 1986), p. 3.

CHAPTER FIVE

ANALYSIS OF THE MONTANA CORPORATION INCOME TAX STRUCTURE

INTRODUCTION

Montana is 1 of 44 states and the District of Columbia that taxes the net income of corporations. Michigan, Nevada, South Dakota, Texas, Washington, and Wyoming do not tax corporations on the basis of net income. Michigan imposes a modified value-added tax, Texas imposes a franchise tax based on net equity, and Washington imposes a gross receipts tax. South Dakota taxes financial institutions on the basis of net income but does not tax other corporations.

Taxes on corporate net income differ significantly among the states in terms of tax rates, methods of apportionment, and definitions of the taxable unit and taxable income. This chapter analyzes the Montana corporation income tax structure. It reviews the rationale for taxing corporate net income, describes the level of corporate income tax collections, and compares the Montana tax structure with that of other states.

RATIONALE FOR TAXING THE INCOME OF CORPORATIONS[1]

There are two major rationales for taxing the net income of corporations. The first is to protect the individual income tax base by including certain corporate source income, such as retained earnings, in the corporation tax base. If corporate income were not taxed, shareholders could hide income within the corporation. The corporate income tax is, however, an imperfect means of getting at this source of income. The tax on retained earnings could cause vertical inequities among shareholders because the rate structure faced by the corporation may be unrelated to the circumstances of the potential taxpayer. Horizontal inequities arise because corporate source income is taxed differently than other sources of income. In addition, shareholders would be subject to double taxation when dividends are paid. Finally, if the corporation tax is not paid by shareholders but is shifted to workers (through lower wages) or consumers (through higher prices), both horizontal and vertical inequities may arise.

The second rationale for taxation of corporations is the benefits-received principle. Corporations receive many services from state and local governments. Net income, however, is a poor measure of the value of services provided. Obviously, corporations with no net income are not taxed (or are taxed minimally) for services. To the extent that a benefit tax is appropriate for corporations, other tax bases may better reflect the value of services received. For example, real and personal property would reflect the value of such services as police and fire protection and improvements to infrastructure. Other taxes, such as a value-added tax or a gross receipts tax, would be better proxies for benefits received. Under value-added taxes or gross receipts taxes, businesses, whether profitable or unprofitable, would be required to pay for services.

MONTANA CORPORATION INCOME TAXES AS A SOURCE OF STATE REVENUE

Montana first levied a tax on the earnings of corporations in 1917. Montana was one of only six states (Connecticut, Missouri, Montana, New York, Virginia, and Wisconsin) and the Territory of Hawaii to impose a corporation income tax by 1917. The initial rate imposed on corporations doing business in the state was 1 percent of net income. The Montana Legislature has increased the tax rate six times since 1917. During the second extraordinary session of the 42nd Legislature, the tax rate was increased from 6.25 percent to 6.75 percent (Ch. 7, 2nd Ex. L. 1971). That rate was made permanent during the 43rd Session of the Legislature (Ch. 5, L. 1974). The current rate is 6.75 percent of net income. (Multistate corporations electing water's-edge are taxed at 7 percent of net income. See below.) Multistate corporations whose only activity in the state consists of making sales and that do not own or rent real or personal property in the state and whose gross receipts do not exceed $100,000 may elect to pay a gross receipts tax of 1/2 of 1 percent (15-31-122, MCA).

In the past 20 years, two distinct trends in Montana corporation income tax collections may be observed (see Table 1). Between 1970 and 1981, total corporation income taxes increased steadily from $9.5 million to $52.9 million, or by an annual rate of about 17 percent. At the same time, corporation income taxes as a percentage of personal income also increased in an almost continuous upward trend, reaching a peak of 0.75 percent in 1981. Although not as consistent, corporation income tax collections as a share of total tax collections generally increased during the period. The percent of total state tax collections derived from the tax averaged slightly over 8 percent between 1970 and 1981. Much of the consistent growth pattern in all three measures of corporation income taxes may be attributable to a relatively robust economy in the state that included energy and mineral development as well as growth in the wood products industry.

Corporate profits, and hence corporate income taxes, are very sensitive to economic fluctuations. Between 1982 and 1990, corporation income tax collections have exhibited the volatility normally associated with this tax. The back-to-back economic recessions of 1980 and 1982, the ups and downs of the natural resource industries, and changes in federal corporate income tax law all contributed to the swings in Montana corporation income tax collections, both in absolute and relative terms.

Table 1: Montana Corporate Net Income Tax Revenue as a Share of Total State Tax Collections and as a Share of Total Personal Income

Fiscal Year	Corp. Tax Revenue (Thousands of Dollars)	Corp. Tax Revenue as a Share of Total Tax Revenue	Corp. Tax Revenue as a Share of Total Personal Income
1990	$80,316	9.36%	0.70%
1989	56,140	7.71%	0.54%
1988	46,200	6.46%	0.46%
1987	34,566	5.85%	0.36%
1986	58,585	9.49%	0.64%
1985	62,671	9.77%	0.70%
1984	35,396	6.07%	0.42%
1983	35,831	6.98%	0.44%
1982	44,630	8.43%	0.57%
1981	52,901	11.38%	0.75%
1980	45,623	10.47%	0.71%
1979	36,092	9.01%	0.62%
1978	29,239	8.64%	0.59%
1977	24,957	7.99%	0.55%
1976	23,020	8.29%	0.55%
1975	22,079	9.49%	0.57%
1974	15,736	7.15%	0.44%
1973	12,057	6.44%	0.40%
1972	11,523	6.30%	0.44%
1971	9,606	7.07%	0.39%
1970	9,536	7.40%	0.43%

Source: U.S. Bureau of the Census, State Government Finance, various years.
U.S. Department of Commerce, Regional Economic Information System.

Following 1981, corporation income taxes fell for 3 successive years. Corporation income tax collections fell dramatically in 1987 before increasing in each of the next 3 years. Corporation income taxes reached an all-time high of $80 million in 1990. A portion of the large increase between 1989 and 1990 is due to the payment of estimated taxes required by House

Bill No. 56 of the June 1989 Special Session (Ch. 9, Sp. L. June 1989).* Corporation income taxes fell to $70.8 million in 1991. Corporation tax collections as a share of total state taxes averaged slightly less than 8 percent from 1982 to 1990.

Table 2 compares the percentage distribution of corporation income taxes with other taxes levied by the state and with the United State average. Corporation income taxes account for less than 10 percent of total tax collections both in Montana and in the nation as a whole. In 1989, corporation taxes were slightly less important in Montana than in the United States. In 1990, they were more important in Montana.**

Table 2: **Percentage Distribution of State Tax Revenue, FY 1989 and FY 1990, Montana and U.S. Average**

	Montana		U.S. Average	
	1989	1990	1989	1990
Individual Income Tax	36.5%	32.6%	31.2%	32.0%
Corporate Income Tax	7.7%	9.4%	8.4%	7.2%
Sales Taxes	24.6%	21.3%	48.7%	48.9%
General Sales	-0-	-0-	32.9%	33.2%
Selective Sales	24.6%	21.3%	15.8%	15.8%
License Taxes	11.0%	10.7%	6.2%	6.3%
Severance Taxes	11.7%	11.2%	1.5%	1.6%
Other Taxes	8.5%	14.8%	4.0%	4.0%

Source: U.S. Bureau of the Census, State Government Tax Collections, 1989 and 1990.

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* House Bill No. 56 was enacted, in part, to deal with the unfunded liability in the workers' compensation fund. Accelerated corporation income taxes (estimated taxes) provided the cash to help reduce the unfunded liability.

** Using 1990 as a comparison year may be somewhat misleading. In that year, the U.S. Bureau of the Census included for the first time property tax revenue from the countywide levies for schools as state tax revenue (and may have counted it as local tax revenue as well). In addition, the corporation estimated tax payments represent one-time revenue.

MONTANA CORPORATION INCOME TAX STRUCTURE

Like most states that impose a corporation income tax, Montana is tied to the federal system. In 1961, the Montana Legislature adopted the federal definition of gross income to include the income from all sources within the state that is recognized in the determination of the corporation's federal income tax liability (Ch. 235, L. 1961). Federal taxable income is the starting point for determining a corporation's Montana tax liability. Several items are added to and subtracted from the federal base. Additions to taxable income include federal, state, or foreign income taxes paid, federal exempt interest, federal capital loss carryovers, and federal net operating losses. Subtractions include federal jobs tax credit, state income tax refunds, computer donations, energy conservation investments, and capital gains and dividends received from a small business investment company.

Corporations can further reduce their tax liability by taking advantage of a wide range of tax credits presumably designed to encourage certain kinds of business activity. These include credits for new or expanding manufacturing industries, investment in wind-generated electricity, investment in a Montana small business company, the provision of employee dependent care, the provision of disability insurance for employees, and contributions to Montana higher education endowment funds. These credits may not be available to all corporations.

Apportionment

Most state corporate income taxes are paid by multistate firms.*[2] In order to allocate net income in a manner reflecting a multistate corporation's activity within a state, most states employ some form of unitary taxation based on formula apportionment. The apportionment formula is applied to the nationwide (or worldwide) income of the firm and its affiliates. A three-factor formula, which considers property, income, and sales, is the most common method of apportionment. This method of allocating income to a state eliminates the possible manipulation of transactions between divisions of the same corporation that would occur under separate accounting. Under separate accounting, the corporation determines, for each state, gross sales, the cost of goods sold, and the cost of all factors of production in order to arrive at the total net income in each state.[3] As a result, income can be allocated to a low-tax state through transfer prices set between divisions of the corporation. It is very difficult to determine whether transfer prices represent arm's length transactions.

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* In Montana, the percentage of corporate income taxes paid by multistate firms varies from year to year. Typically, 100 corporations pay about 50 percent of the corporation income tax. Of those corporations, 70 to 80 percent are multistate firms.

Montana requires worldwide unitary combination for tax purposes unless a corporation elects water's-edge combination. Under worldwide combination, affiliates operating anywhere in the world are included in a combined report if they are engaged in a unitary business with the firm operating in Montana. A multistate firm is part of a unitary group if the activity of the business is "dependent upon or contributory to" business activity outside the state (other states or foreign countries). If a domestic corporation operates worldwide, its worldwide net income would be apportioned to Montana under the formula. Similarly, a foreign parent corporation operating in the state would also be subject to worldwide unitary taxation. On the other hand, the income of the foreign parent would not be subject to worldwide apportionment if its only presence in the state is through a United States subsidiary corporation. Several states employ a domestic unitary apportionment; that is, only corporations created or organized in the United States are included in the unitary group.

Although the U.S. Supreme Court has liberalized state use of the worldwide unitary concept, pressure from foreign countries as well as multinational corporations headquartered in the United States has caused a number of states to modify the application of the worldwide principle.[4] In 1984, 12 states employed some version of the worldwide unitary concept.[5] By 1991, only Alaska required worldwide unitary combination. Several states, including California, Idaho, Indiana, Montana, North Dakota, and Utah, provide for a water's-edge election.[6] Under this election, foreign firms not operating in the United States are excluded from the combined report; that is, combination stops at "water's-edge".

In 1987, the Montana Legislature allowed corporations to make a water's-edge election (Ch. 616, L. 1987). According to the Montana Department of Revenue, 25 corporations have elected water's-edge for Montana tax purposes.[7] Although a water's-edge election may result in a significant reduction in tax liability, it may also result in a more complicated tax return filing procedure.

Net income of a multistate firm doing business in Montana is allocated by a three-factor, simple-average apportionment formula. That is, the proportion of total net income that is allocated to Montana is the average of the fraction of total property of the business in the state, the fraction of total payroll paid in the state, and the percentage of total sales occurring within the state. Suppose, for example, that one quarter of a multistate firm's property is in Montana, one quarter of its payroll is paid in Montana, and one half of its sales occur in Montana. By formula apportionment, one third of the multistate firm's net income would be subject to taxation in Montana: $[(1/4 + 1/4 + 1/2)/3] = 1/3$.

Interstate Tax Comparisons

Forty-four states and the District of Columbia impose a tax on corporate income. Nevada, Texas, Washington, and Wyoming do not tax corporate income. Michigan uses a single-business tax (modified value-added tax). South Dakota taxes only the net income of financial institutions. A few states that tax corporate income impose different rates on financial institutions. Montana imposes the same tax rate on financial institutions as on other corporations but distributes the tax revenue from financial institutions in a different manner. Beginning in 1979, the Montana Legislature imposed the corporation income tax on financial institutions to replace lost local property tax revenue from the repeal of the tax on moneyed capital and bank shares (Ch. 634, L. 1979). Eighty percent of the tax collected from financial institutions is allocated to the county in which the institution is located, and 20 percent is allocated to the state.

Fifteen states use a graduated rate structure. Alaska has the most steeply graduated structure (10 brackets), ranging from 1 percent on the first $10,000 of net income to 9.4 percent on net income over $90,000. Iowa has the highest maximum statutory tax rate of the states employing a graduated rate structure (6 percent on the first $25,000 of net income to 12 percent on net income over $250,000).

Table 3 compares the corporate income tax rates and apportionment formulas for Montana and eight other states.* Six of the comparison states impose a flat tax rate on corporate income, while Colorado, New Mexico, and North Dakota have graduated structures. Arizona abandoned its seven-tier rate structure beginning in tax year 1990, while Minnesota abandoned its two-tier rate structure beginning in tax year 1987. Colorado will impose a flat rate beginning July 1, 1993. Both Arizona and Minnesota weight the apportionment formula more heavily to sales. The purpose of weighting sales in the apportionment formula is to increase the taxable income in the state of those (usually out-of-state) firms with limited physical presence in the state but with significant sales activity. The remaining states use a three-factor, simple-average formula. Only North Dakota allows a deduction for federal income taxes paid.

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* These states served as the initial comparison states for the examination of Montana state employee compensation issues under the study directed by House Bill No. 786 (Ch. 660, L. 1989). Nevada, South Dakota, Washington, and Wyoming were part of that study, but they do not tax the income of corporations.

Table 3: Corporation Income Tax Characteristics of Montana and Surrounding States for 1991				
	Range of Rates	Minimum Taxable Income for Top Bracket	Unitary	Apportionment Formula
Arizona	9.3%	All	Domestic	Property (25%), Payroll (25%), Sales (50%)
Colorado	5.0-5.5% (2)	$50,001	Water's-edge required	3-factor, simple average or average of sales & property only (UDITPA)*
Idaho	8.0%	All	Water's-edge election	3-factor, simple average (UDITPA)
Minnesota	9.8%	All	Domestic	3-factor with 70% weighted sales
Montana	6.75%	All	Worldwide unless water's-edge	3-factor, simple average (UDITPA)
New Mexico	4.8-7.6% (3)	$1,000,001 +	Optional-domestic	3-factor, simple average (UDITPA)
North Dakota	3.0-10.5% (6)	$50,001 +	Worldwide unless water's-edge	3-factor, simple average (UDITPA)
Oregon	6.6%	All	Domestic consolidated	3-factor, simple average (UDITPA)
Utah	5.0%	All	Water's-edge or option for worldwide	3-factor, simple average (UDITPA)

Notes:

Arizona	Minimum tax is $50.
Colorado	Beginning after June 30, 1993, all net income will be taxed at 5%.
Idaho	Minimum tax is $20. There is an additional tax of $10 on each corporation filing a return and having gross income during the tax year.
Minnesota	An alternative minimum tax is imposed equal to 5.8% of Minnesota alternative taxable income. A franchise fee is also imposed ($0-$5,000 based on Minnesota property, payroll, and sales).
Montana	Minimum tax is $50, except $10 for small business corporations. The tax rate for water's-edge election is 7%.
North Dakota	Minimum tax is $50.
Oregon	Minimum tax is $10.
Utah	Minimum tax is $100.

* UDITPA means Uniform Division of Income for Tax Purposes Act of the Multistate Tax Compact.

Source: Significant Features of Fiscal Federalism, U.S. Advisory Commission on Intergovernmental Relations, 1992 Edition, Vol. 1.

Table 4 shows the relative share of corporation income taxes to total state tax collections for Montana and the comparison states. In 1990, the corporation income tax contributed 9.4 percent of total state tax revenue collections in Montana. This share was above the U.S. average of 7.2 percent. Montana also relied more heavily on the corporation income tax than did any of the comparison states in 1990.

Between 1980 and 1990, Montana's reliance on the corporation income tax fell from 10.5 percent to 9.4 percent, while the U.S. average fell from 9.7 percent to 7.2 percent. With the exception of Utah, the reliance on this tax in the comparison states also declined, in some cases dramatically (e.g., Minnesota and Oregon). Montana has typically been more reliant on the corporation income tax than have the comparison states.

Table 4: **Corporation Net Income Tax as a Share of Total State Tax Revenue and as a Share of State Personal Income**

	FY 1980		FY 1985		FY 1990	
State	Percent of Total Tax Revenue	Percent of Personal Income	Percent of Total Tax Revenue	Percent of Personal Income	Percent of Total Tax Revenue	Percent of Personal Income
Arizona	7.0%	0.54%	6.9%	0.55%	4.1%	0.32%
Colorado	7.4%	0.91%	4.4%	0.23%	4.2%	0.21%
Idaho	8.7%	0.58%	5.8%	0.41%	6.4%	0.51%
Minnesota	11.9%	1.75%	7.3%	0.69%	7.1%	0.62%
Montana	10.5%	0.71%	9.8%	0.70%	9.4%	0.71%
New Mexico	5.0%	0.48%	4.4%	0.43%	3.1%	0.31%
North Dakota	9.8%	0.67%	12.2%	1.06%	6.9%	0.52%
Oregon	12.2%	0.75%	7.8%	0.48%	5.3%	0.33%
Utah	5.1%	0.38%	3.9%	0.66%	5.3%	0.42%
United States	9.7%	0.66%	8.2%	0.57%	7.2%	0.55%

Source: For state tax revenue, U.S. Bureau of the Census, State Government Finance, various years. For personal income, U.S. Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1989 Edition, Vol. 1, and U.S. Department of Commerce, Survey of Current Business, August 1991.

Table 4 also shows corporation income tax revenue as a percentage of total state personal income. A similar pattern is evident for this measure. Corporation income taxes as a share of personal income typically have been higher in Montana than the U.S average as well as higher than the comparison states. The range for the comparison states over the 11-year period ranged from 1.75 percent (Minnesota, 1980) to 0.21 percent (Colorado, 1990).

Although Montana appears to be slightly more reliant on the corporation income tax as a source of tax revenue, interstate differences in the corporate income tax base, tax rates, credits, and the inherent instability of corporation income tax collections account, at least in part, for the differences shown in Table 4. Information contained in Table 4 would indicate that corporation income taxes in Montana are fairly stable. However, as Table 1 shows, since 1982, stability has not been the case. In addition, the share of personal income in the state devoted to corporation taxes is not so reliable a measure of tax burden experienced by residents of the state as it is for the personal income tax. One reason is that it is difficult to determine the final incidence of the corporation income tax and how much of the tax is exported.

SUMMARY AND CONCLUSIONS

The corporation net income tax is a relatively minor component of Montana's tax revenue structure. However, the imposition of the tax protects the personal income tax base by including income that would otherwise escape taxation. The corporation income tax appears to be relatively more important in Montana than in other states, and it takes a slightly higher share of state personal income than it does in the nation as a whole. The statutory tax rate is not high compared to other states, although the net income base may be greater because Montana uses the worldwide unitary combination.

It is difficult to evaluate the equity of the corporation income tax because the final incidence of the tax is not known. Regardless of who pays the tax, whether shareholders, workers, or consumers, vertical and horizontal inequities may arise. The tax has been justified on the benefits-received principle, but net income is a poor measure of benefit taxes.

The corporation income tax is a convenient revenue-raising source, but it is inherently unstable because of the cyclical nature of the tax. The instability of the tax is compounded by net operating loss carrybacks and carryforwards. Because of these factors, it is difficult to accurately forecast tax revenue from this source.

Despite its weaknesses, the corporation income tax is a familiar and generally accepted form of taxation. Changes to the existing corporation income tax structure, however, could be accomplished in a variety of ways. A graduated rate schedule, for example, could be imposed. Depending on its structure, a graduated system could increase revenue, but it could exacerbate the inherent inequities of the tax. The imposition of an alternative minimum tax or the elimination of carryover provisions for net operating losses could reduce some of the revenue instability. The worldwide unitary combination could be replaced with domestic unitary combination. Some economists argue that domestic unitary combination enhances simplicity, fairness, and competitiveness.[8]

A more radical alternative would be to eliminate the current structure and adopt a new method of taxation, such as a value-added tax. There are several advantages to a value-added tax. First, the tax would be imposed on all business activity regardless of the legal form of organization (sole proprietorship, partnership, or corporation). As such, the imposition of a value-added tax would reflect more closely the concept of a benefits tax. Because the tax base is so much broader under a value-added tax, the tax rate may be much lower than under a net income tax. As a tax on business activity rather than on profits, the value-added tax is a relatively stable revenue source. A significant disadvantage of the tax is that it does not resolve the vertical and horizontal equity problems inherent in the corporation net income tax.

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ENDNOTES

1. Suggested by analysis contained in the Final Report of the Minnesota Tax Study Commission: Findings and Recommendations, Vol. 1 (St. Paul: Butterworth Legal Publishers, 1986), pp. 199-200.

2. Michael Vlaisavljevich, "State Business Taxes: The Policy and Research Agendas," in The Unfinished Agenda for State Tax Reform, Steven D. Gold (ed.), (Denver: National Conference of State Legislatures, 1988), p. 187.

3. Therese J. McGuire, "The Corporation Income Tax," in State and Local Finance for the 1990s: A Case Study of Arizona, Therese J. McGuire and Dana Wolfe Naimark (eds.), (Tempe, Arizona: School of Public Affairs, Arizona State University, 1986), p. 81.

4. Robert P. Strauss, "Business Taxes", in Reforming State Tax Systems, Steven D. Gold (ed.), (Denver: National Conference of State Legislatures, 1986), p. 232.

5. Ibid., Note 4, p. 255.

6. Significant Features of Fiscal Federalism, Vol. 1 (Washington, D.C.: U.S. Advisory Commission on Intergovernmentel Relations, February 1992), Table 26, pp. 79-85.

7. Telephone conversation with Lynn Chenoweth, Corporation Tax Bureau Chief, Natural Resource and Corporation Tax Division, Montana Department of Revenue, June 4, 1992.

8. See, for example, the Final Report of the Minnesota Tax Study Commission, p. 217.

APPENDIX

State of Montana
Stan Stephens, Governor

Department of Revenue
Denis Adams, Director

Room 455, Sam W. Mitchell Building
Helena, Montana 59620

March 19, 1992

TO: Revenue Oversight Committee

FROM: Denis Adams
Director

SUBJECT: Individual Income Tax Liability by Taxpayer Income Class

This report provides: 1) the amount of tax liability paid by Montana taxpayers by decile group for tax year 1990; and 2) a 10-year review of growth in income and tax collections.

TAX YEAR 1990 TAX LIABILITY BY TAXPAYER INCOME CLASS

Montana's 1990 individual income tax liability totaled $273 million, with the top ten percent of Montana's income earners paying 53 percent of that amount, and the lower half paying 5.6 percent.

These figures come from an analysis of the individual income tax liability figures by the state's tax agency. A review of this data shows considerable variations in the amount of taxes paid within different decile groups. (Each decile group contains 10 percent of all filers, with the lowest income filers in Group 1 increasing to the wealthiest filers in Group 10.)

As shown in Table 1, 50 percent of the taxpayers have income up to $11,787; but this 50 percent pays only 5.6 percent of the tax liability. Taxpayers with income in the top 10 percent of all taxpayers pay 53 percent of the tax liability. The top 1 percent pays 21.6 percent of the total state individual income tax liability.

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Table 1
Tax Liability Paid By Income Level of Taxpayer

Decile Group	Income Up To	Montana Adjusted Gross Income MAGI	% of MAGI	Tax Liability	% of Tax Liab.
1	$1,706	$(441,538,965)	(6.3)	83,220	0.0
2	3,775	82,237,581	1.2	734,759	0.3
3	6,053	157,980,809	2.3	2,086,716	0.8
4	8,692	255,520,260	3.7	4,419,351	1.6
5	11,787	382,541,379	5.5	7,885,274	2.9
6	15,421	543,094,777	7.8	13,346,778	4.9
7	19,954	751,106,519	10.8	20,780,832	7.6
8	25,970	1,023,403,053	14.7	31,100,623	11.4
9	35,652	1,388,044,983	19.9	47,863,932	17.5
10	Above	2,826,797,652	40.6	144,583,710	53.0
Total		$6,969,188,048	100.0	$272,885,195	100.0
Top 1%	above $90,383	$ 890,796,799	12.8	$ 59,034,669	21.6

TEN YEAR ANALYSIS OF MAGI AND TAX COLLECTIONS

Table 2* shows the change in tax liability of the first five decile groups (representing 50 percent of Montana's taxpayers) and the top 10 percent of Montana taxpayers over the 1981-1990 period. The percent of tax paid by the first five groups decreased from 8.2 percent in 1981 to 5.6 percent in 1990 while the top income category (decile group 10) saw their tax payments rise from 43 percent of the total to 53 percent.

In dollar amounts, the first five decile groups total tax payments grew from $12.7 million in 1981 to $15.2 million in 1990, a 20 percent rise. Over the same period, the tenth decile group's tax payments shot up from $66.7 million to $144.6 million, a 117 percent increase. During this same ten year period, the consumer price index rose 44 percent.

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* Attachments 1 and 2 show the detailed decile group statistics for tax years 1981 to 1990.

Table 2
TAX LIABILITY AS A PERCENT OF TOTAL LIABILITY
Bottom Half and Top Ten Percent of All Returns
Tax Years 1981 to 1990

	----- Bottom Half -----		---- Top Ten Percent ----	
Year	Tax Liability	% of Total	Tax Liability	% of Total
1981	$ 12,698,075	8.2	$ 66,697,154	43.0
1982	12,256,142	7.7	71,052,622	44.7
1983	12,685,092	7.6	74,099,234	44.2
1984	13,515,750	7.6	79,872,627	44.8
1985	12,490,982	7.3	76,902,308	45.0
1986	12,261,738	7.1	80,027,472	46.0
1987	14,342,108	6.2	113,112,379	49.2
1988	15,231,253	5.5	150,336,343	54.5
1989	13,774,528	5.2	148,694,125	55.9
1990	15,209,320	5.6	144,583,710	53.0

Table 3 shows that over the last 10 years Montana adjusted gross income (MAGI) increased 42 percent from $4.9 billion to $6.97 billion dollars. At the same time, tax liabilities increased from $155 million to $273 million, or 76 percent. In ten years the tax liabilities grew almost twice as fast as income.

Table 3
Montana Adjusted Gross Income and Tax Liability for Tax Years 1981 to 1990

Tax Year	MT Adjusted Gross Income	Tax Liabilities
1981	$4,914,718,978	$154,954,40c4
1982	5,026,529,502	158,789,644
1983	5,144,748,708	167,677,873
1984	5,382,807,872	178,442,638
1985	5,292,505,863	171,067,177
1986	5,383,685,603	173,895,219
1987	5,828,673,190	229,894,842
1988	6,469,369,857	275,677,287
1989	6,849,518,523	265,900,086
1990	6,969,188,048	272,885,195
1981-1990	41.8%	76.1%

Table 4 compares the 10-year change in MAGI to the 10-year change in tax liability by decile group. Montana adjusted gross income (MAGI) grows faster for decile groups 2 through 5 than the tax liability. MAGI increases less than tax liability for the top five decile groups. Overall, MAGI grows 42 percent while tax liability grows 76 percent. (Decile group 1 contains households with negative MAGI. Between 1981 and 1990, income in this group decreased from $(263) million to $(431) million.)

Table 4
Comparison of Percent Change in MAGI and Tax Liability
Tax Years 1981-1990

Decile Group	MAGI % Change 1981-1990	Tax % Change 1981-1990
1	(64)	(23)
2	27	6
3	28	9
4	31	22
5	31	24
6	33	34
7	33	42
8	33	50
9	36	58
10	64	117
Total	42%	76%

Federal Tax Reform Act of 1986

Both Table 2 and Table 3 show a large change in tax liability in 1987 and 1988. While adjusted gross income grew from $5.4 million in 1986 to $5.8 million in 1987, or by 8.3 percent, tax liability grew 13 percent. Adjusted gross income grew from $5.8 million in 1987 to $6.5 million in 1988, or 11 percent, while tax liability over the same year grew 25.2 percent. Tax liability increased much more than income due primarily to the Federal Tax Reform Act of 1986. Montana kept all the tax revenue generated by the federal changes rather than adjust state tax law to keep tax growth constant with income. Major federal changes which increased Montana income tax liability include:

1) repealing the 60 percent capital gains exclusion;
2) restricting the use of passive income losses;

3) repealing the dividend income exclusion;
4) limiting deductions related to moving expenses, employee business expenses, and miscellaneous itemized deductions;
5) limiting deductions for payments to an IRA;
6) limiting medical expense deductions;
7) repealing the personal interest deductions; and
8) limiting the deduction for investment interest.

Indexing Montana's Individual Income Tax

Montana began indexing it's individual income tax in tax year 1981 to provide taxpayers protection against tax increases that arise purely as a consequence of inflation. Over the period 1981-1990, indexing has reduced individual income tax liabilities $364.7 million. The reduction in each tax year since 1981 is shown in the following table:

Table 5
Reduction in Tax Liability Due to Indexing

Year	Reduction Due to Indexing
1981	$ 9,675,000
1982	$ 16,630,000
1983	$ 20,103,000
1984	$ 24,760,000
1985	$ 29,866,000
1986	$ 31,937,000
1987	$ 44,928,000
1988	$ 54,592,000
1989	$ 59,089,000
1990	$ 73,141,000
Total Reduction	$364,721,000

Table 6 shows how indexing has changed the exemption level, standard deduction amounts, and the income tax rate tables over the 1981-1990 period. In general, these amounts have increased about 57 percent over the period.

Table 6
1980 - 1990 Individual Income Tax Parameter Changes Due to Indexing

	Base Year (1980)	Tax Year 1990	% Change
Consumer Price Index	247.6	389.1	57.1
Exemption Level	$ 800	$1,260	57.5
Standard Deduction Maxima			
- Single	1,500	2,360	57.3
- Joint	3,000	4,720	57.3
Rate Table Boundaries:			
2%	$ - 0 -	$ - 0 -	N/A
3%	1,000	1,600	60.0
4%	2,000	3,100	55.0
5%	4,000	6,300	57.5
6%	6,000	9,400	56.7
7%	8,000	12,600	57.5
8%	10,000	15,700	57.0
9%	14,000	22,000	57.1
10%	20,000	31,400	57.0
11%	35,000	55,000	57.1

Who Benefits from Indexing

Table 7 shows the benefits from indexing on Montana residents in tax year 1990, by decile group. In 1990, Montanans benefitted from indexing by having total liabilities reduced $70.3 million. Households with income of less than $18,000 (bottom half of households) saw their group liability reduced by 35 percent, while households with incomes of over $51,432 (the top 10 percent of households) saw a reduction in group liability of 14 percent. Households with less than $40,000 in income received nearly 54 percent of the tax relief from indexing in tax year 1990. (Decile group income ranges in Table 7 are different from those in Table 1 because they are based on "total income" and "households". Decile group income ranges in Table 1 were based on MAGI and individual taxpayers.)

Table 7
Percent Reduction in Tax Liability Due to Indexing
Tax Year 1990

Decile : Income Range	----- Tax Liability With Indexing	----- W/O Indexing	Difference	Percent Reduction
1 : $ 0 - $ 2,953	$114,817	$278,799	$163,982	59%
2 : $ 2,953 - $ 6,085	1,103,445	1,795,738	692,293	39%
3 : $ 6,085 - $ 9,590	2,694,982	4,083,680	1,388,698	34%
4 : $ 9,590 - $ 13,238	4,772,272	7,375,978	2,603,706	35%
5 : $13,238 - $ 17,956	8,434,560	12,853,230	4,418,670	34%
6 : $17,956 - $ 23,484	13,782,746	20,392,260	6,609,514	32%
7 : $23,484 - $ 30,404	20,761,319	29,620,580	8,859,261	30%
8 : $30,404 - $ 38,822	31,673,511	43,023,488	11,349,977	26%
9 : $38,822 - $ 51,432	46,094,621	60,043,905	13,949,284	23%
10 : $51,432 +	128,286,785	148,565,584	20,278,799	14%
Total	$257,719,058	$328,033,242	$70,314,184	21%

The National Governors' Association, Center for Policy Research, "State Services Note 2" states:

> In general, however, low-and moderate-income persons, particularly the elderly and those with large families, receive relatively greater tax benefits from indexation in a majority of states. This occurs for several reasons.
>
> - First, the inflation erosion of the personal exemptions and standard deduction has a greater tax impact on these groups, a fact that is compounded by additional exemptions or deductions for low-income and elderly person in some states.
> - Second, the degree of progressivity in many state income taxes declines as income increases because the maximum tax rate bracket is set at a rather low level, the upper-income brackets widen or the rate graduation declines. These factors reduce or eliminate the impact of being pushed into higher tax brackets by inflation.
> - Finally, taxpayers who itemize their tax deductions (generally those with higher incomes) are somewhat protected from the inflation-related tax increases because most itemized deductions tend to be "self-indexing." They are generally based on actual expenditures without fixed limits, and their value increases along with inflation, which prevents the tax-exempt income of those individuals who itemize deductions from being eroded by inflation.

The California Legislative Analyst report on "The Fiscal Implications of Income Tax Indexing in California" states:

> While the dollar benefits from indexing tend to increase with income, exactly the opposite is true with respect to the percentage reduction in tax liabilities. In fact, probably the most obvious and important implication of indexing for the distribution of the tax burden is that taxpayers in high income brackets benefit far less in relative terms from indexing than do taxpayers in middle and lower income brackets.

Suspending Indexing

Suspending indexing would act to increase tax liabilities and tax revenue to the state. The impact of suspending indexing depends on several factors including the size of a state's tax base, the number of households itemizing deductions, whether or not a surtax is in effect, etc. The biggest factor, however, is probably the rate of inflation. When inflation is high relative to wages and other income, impacts from suspending indexing are large, but when inflation is low so are the impacts from suspending indexing.

Tables 8, 9, and 10 show the projected impacts of suspending indexing for tax years 1992, 1993, and both years combined.

Suspending indexing would increase tax liabilities about $5.4 million in tax year 1992, and $13 million in tax year 1993, for a total increase of about $18.4 million for the two-year period. The poorest one-tenth of Montana households would experience a 13.4 percent increase in tax liability, while the wealthiest one-tenth of Montana households would experience a 2 percent increase in liability.

However, on a dollar basis, the poorest one-tenth of households would experience a tax increase of $35,000, or about 0.2 percent of the total increase, while the wealthiest one-tenth of Montana households would experience an increase of $5.5 million, or about 30 percent of the total increase.

Table 8

Impact of Suspending Indexing --- CY 1992 Tax Liability

Decile : Income Range	----- Tax Liability With Indexing	----- W/O Indexing	Change	Percent Increase	Percent of Total Increase
1 : $ 0 – $ 2,953	$128,854	$138,748	$9,894	7.7%	0.2%
2 : $ 2,953 – $ 6,085	1,197,248	1,248,174	50,926	4.3%	0.9%
3 : $ 6,085 – $ 9,590	2,933,679	3,028,056	94,377	3.2%	1.7%
4 : $ 9,590 – $ 13,238	5,364,096	5,538,705	174,609	3.3%	3.2%
5 : $ 13,238 – $ 17,956	9,554,959	9,856,514	301,555	3.2%	5.6%
6 : $ 17,956 – $ 23,484	16,297,871	16,749,055	451,184	2.8%	8.3%
7 : $ 23,484 – $ 30,404	24,423,701	25,095,777	672,076	2.8%	12.4%
8 : $ 30,404 – $ 38,822	38,066,663	38,946,756	880,093	2.3%	16.3%
9 : $ 38,822 – $ 51,432	54,130,005	55,250,730	1,120,725	2.1%	20.7%
10 : $ 51,432 +	137,977,377	139,631,384	1,654,007	1.2%	30.6%
Total	$290,074,453	$295,483,899	$5,409,446	1.8%	

Table 9

Impact of Suspending Indexing --- CY 1993 Tax Liability

Decile : Income Range	----- Tax Liability With Indexing	----- W/O Indexing	Change	Percent Increase	Percent of Total Increase
1 : $ 0 – $ 2,953	$133,978	$159,330	$25,352	18.9%	0.2%
2 : $ 2,953 – $ 6,085	1,244,324	1,366,639	122,315	9.8%	0.9%
3 : $ 6,085 – $ 9,590	3,063,290	3,288,208	224,918	7.3%	1.7%
4 : $ 9,590 – $ 13,238	5,603,337	6,032,919	429,582	7.7%	3.3%
5 : $ 13,238 – $ 17,956	9,981,477	10,718,945	737,468	7.4%	5.7%
6 : $ 17,956 – $ 23,484	17,023,297	18,144,296	1,120,999	6.6%	8.6%
7 : $ 23,484 – $ 30,404	25,575,960	27,226,157	1,650,197	6.5%	12.7%
8 : $ 30,404 – $ 38,822	39,734,177	41,855,404	2,121,227	5.3%	16.3%
9 : $ 38,822 – $ 51,432	56,494,233	59,177,702	2,683,469	4.7%	20.7%
10 : $ 51,432 +	144,092,642	147,959,400	3,866,758	2.7%	29.8%
Total	$302,946,715	$315,929,000	$12,982,285	4.1%	

Table 10

Impact of Suspending Indexing --- Biennial Tax Liability (CY 1992 and CY 1993)

Decile : Income Range	----- Tax Liability With Indexing	----- W/O Indexing	Change	Percent Increase	Percent of Total Increase
1 : $ 0 – $ 2,953	$262,832	$298,078	$35,246	13.4%	0.2%
2 : $ 2,953 – $ 6,085	$2,441,572	$2,614,813	173,241	7.1%	0.9%
3 : $ 6,085 – $ 9,590	$5,996,969	$6,316,264	319,295	5.3%	1.7%
4 : $ 9,590 – $ 13,238	$10,967,433	$11,571,624	604,191	5.5%	3.3%
5 : $ 13,238 – $ 17,956	$19,536,436	$20,575,459	1,039,023	5.3%	5.6%
6 : $ 17,956 – $ 23,484	$33,321,168	$34,893,351	1,572,183	4.7%	8.5%
7 : $ 23,484 – $ 30,404	$49,999,661	$52,321,934	2,322,273	4.6%	12.6%
8 : $ 30,404 – $ 38,822	$77,800,840	$80,802,160	3,001,320	3.9%	16.3%
9 : $ 38,822 – $ 51,432	$110,624,238	$114,428,432	3,804,194	3.4%	20.7%
10 : $ 51,432 +	$282,070,019	$287,590,784	5,520,765	2.0%	30.0%
Total	$593,021,168	$611,412,899	$18,391,731	3.0%	

Appendix 1
Montana Individual Income Tax
Distribution of MAGI, by MAGI Decile Group

Decile Group	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	% Change 1981–1990
1	(263,080,387)	(338,245,071)	(334,906,622)	(388,282,240)	(467,383,746)	(424,536,652)	(370,900,124)	(334,421,108)	(338,018,009)	(431,195,550)	-64%
2	91,287,760	95,331,022	101,156,120	105,624,944	102,860,128	101,817,923	104,058,577	107,746,144	109,018,524	116,222,093	27%
3	162,438,758	164,693,746	171,158,280	180,928,262	178,669,191	176,970,318	182,910,458	190,514,834	194,916,159	208,377,278	28%
4	238,820,948	244,743,094	251,863,303	265,589,823	263,170,903	261,219,260	270,662,861	285,697,248	294,797,467	312,524,834	31%
5	330,750,965	338,734,010	345,191,380	365,819,709	361,372,322	360,950,903	378,344,812	396,733,447	410,794,407	434,716,458	31%
6	434,361,959	444,916,524	456,525,689	482,451,030	477,482,029	478,384,268	501,723,758	527,614,980	546,362,660	577,302,124	33%
7	565,592,099	575,873,602	591,669,718	623,611,010	618,854,882	619,103,427	653,357,224	682,543,668	712,739,861	749,660,069	33%
8	728,206,505	747,576,269	766,408,978	803,918,030	803,129,746	801,164,690	843,851,000	884,224,525	924,762,915	971,915,523	33%
9	952,702,563	978,385,310	1,002,745,634	1,048,804,125	1,056,650,257	1,056,085,878	1,110,942,636	1,172,250,323	1,228,833,889	1,291,329,184	36%
10	1,673,637,808	1,774,520,996	1,792,936,228	1,894,343,179	1,897,700,151	1,952,525,588	2,153,721,989	2,556,465,793	2,765,310,651	2,738,336,035	64%
Total	4,914,718,978	5,026,529,502	5,144,748,708	5,382,807,872	5,292,505,863	5,383,685,603	5,828,673,190	6,469,369,857	6,849,518,523	6,969,188,048	42%

Distribution of Tax Liability, by MAGI Decile Group

Decile Group	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	% Change 1981–1990
1	107,729	98,737	106,586	104,276	82,573	77,629	90,130	90,602	75,725	83,220	-23%
2	695,832	700,692	746,259	790,699	705,760	673,957	733,819	763,441	663,301	734,759	6%
3	1,910,642	1,798,383	1,872,179	2,002,262	1,843,411	1,776,676	2,024,769	2,123,811	1,887,942	2,086,716	9%
4	3,631,086	3,509,790	3,642,861	3,883,081	3,592,581	3,531,169	4,082,122	4,389,944	3,966,402	4,419,351	22%
5	6,352,786	6,148,540	6,317,207	6,735,432	6,266,657	6,202,307	7,411,268	7,863,455	7,181,158	7,885,274	24%
6	9,973,144	9,780,745	10,297,216	10,922,930	10,272,723	10,215,371	12,360,195	13,215,338	12,137,305	13,346,778	34%
7	14,664,671	14,405,858	15,423,384	16,290,313	15,481,773	15,400,669	19,175,240	20,301,893	19,020,722	20,780,832	42%
8	20,702,698	20,817,226	22,410,309	23,468,446	22,560,824	22,412,953	28,307,214	30,224,933	28,503,453	31,100,623	50%
9	30,218,662	30,477,051	32,762,638	34,372,572	33,358,566	33,577,016	42,597,704	46,367,527	43,769,953	47,863,932	58%
10	66,697,154	71,052,622	74,099,234	79,872,627	76,902,308	80,027,472	113,112,379	150,336,343	148,694,125	144,583,710	117%
Total	154,954,404	158,789,644	167,677,873	178,442,638	171,067,177	173,895,219	229,894,842	275,677,287	265,900,086	272,885,195	76%

Appendix 2
Montana Individual Income Tax
Percentage Distribution of MAGI, by MAGI Decile Group

Decile Group	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1	-5%	-7%	-7%	-7%	-9%	-8%	-6%	-5%	-5%	-6%
2	2%	2%	2%	2%	2%	2%	2%	2%	2%	2%
3	3%	3%	3%	3%	3%	3%	3%	3%	3%	3%
4	5%	5%	5%	5%	5%	5%	5%	4%	4%	4%
5	7%	7%	7%	7%	7%	7%	6%	6%	6%	6%
6	9%	9%	9%	9%	9%	9%	9%	8%	8%	8%
7	12%	11%	12%	12%	12%	11%	11%	11%	10%	11%
8	15%	15%	15%	15%	15%	15%	14%	14%	14%	14%
9	19%	19%	19%	19%	20%	20%	19%	18%	18%	19%
10	34%	35%	35%	35%	36%	36%	37%	40%	40%	39%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Percentage Distribution of Tax Liability, by MAGI Decile Group

Decile Group	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1	0.1%	0.1%	0.1%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
2	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.3%	0.3%	0.2%	0.3%
3	1.2%	1.1%	1.1%	1.1%	1.1%	1.0%	0.9%	0.8%	0.7%	0.8%
4	2.3%	2.2%	2.2%	2.2%	2.1%	2.0%	1.8%	1.6%	1.5%	1.6%
5	4.1%	3.9%	3.8%	3.8%	3.7%	3.6%	3.2%	2.9%	2.7%	2.9%
6	6.4%	6.2%	6.1%	6.1%	6.0%	5.9%	5.4%	4.8%	4.6%	4.9%
7	9.5%	9.1%	9.2%	9.1%	9.1%	8.9%	8.3%	7.4%	7.2%	7.6%
8	13.4%	13.1%	13.4%	13.2%	13.2%	12.9%	12.3%	11.0%	10.7%	11.4%
9	19.5%	19.2%	19.5%	19.3%	19.5%	19.3%	18.5%	16.8%	16.5%	17.5%
10	43.0%	44.7%	44.2%	44.8%	45.0%	46.0%	49.2%	54.5%	55.9%	53.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

September 23, 1992

TO: Revenue Oversight Committee

FROM: Denis Adams, Director of Revenue

SUBJECT: Report on Corporation License Tax

PURPOSE

As requested by the Committee, this report summarizes data from the corporation license tax returns, as well as presents revenue impacts associated with several graduated rate structures. All of the summary data and revenue estimates are based on Fiscal Year 1992.

SUMMARY OF RETURNS AND GENERAL INFORMATION

The State of Montana imposes a tax on corporations of 6.75% of taxable income. There were 22,058 corporations which filed Montana corporate returns in fiscal year 1992. Of this number, 15,501 were regular corporations, and 6,556 were small business corporations (IRS S-corps). Total Montana Taxable Income from all regular corporate returns was $462 million which resulted in a tax liability of $54.6 million during FY92. Table 1 shows the breakdown of returns by corporation type, status, taxable income, and tax liability.

Table 1

Corporation Type
FY92

Type	Corporations	Montana Taxable Income	Tax Liability
Regular	15,501	$462,002,931	$54,557,515
- Income	6,854	771,414,539	54,125,165
- Loss	4,365	(309,411,608)	218,250
- Neutral	4,282	0	214,100
Small Business	6,556	217,171,956	65,560
TOTAL	22,058	$679,174,887	$54,623,075

More returns were filed by corporations in the service industry (SIC 7,000 - 7,999) than any other industry group. Wholesale and retail trade returns were the second most filed with 4,125 returns. The number of tax returns filed by industry group is outlined in Table 2.

Table 2

Returns Filed by Industry

Industry	Number of Corporations
Agriculture	3,498
Mining	1,356
Construction	1,680
Manufacturing	1,538
Transportation & Util.	933
Wholesale & Retail Trade	4,125
Finance, Insurance & R.E.	3,049
Services	4,139
Other	71
No grouping	1,669
TOTAL	22,058

Table 3 shows the top 100 corporate taxpayers by industry group. The transportation and public utility group of the top 100 taxpayers had the highest tax liability ($11,962,804). The top 100 taxpayers as a whole were responsible for $33.4 million of the $54.7 million total tax liability (61%).

Table 3

Top 100 Taxpayers
By Industry

Industry	Standard Industrial Code	# of Corps	Tax Liability
Agriculture	100 - 999	1	suppressed
Mining	1,000 - 1,499	2	suppressed
Construction	1,500 - 1,799	3	suppressed
Manufacturing	1,800 - 3,999	23	6,092,271
Transportation & Util.	4,000 - 4,999	12	11,962,804
Wholesale & Retail Trade	5,000 - 5,999	18	3,506,229
Finance, Insurance & R.E.	6,000 - 6,999	27	4,869,009
Services	7,000 - 8,999	1	suppressed
No grouping	None	13	5,660,947
Total		100	$33,390,687

Banks and savings and loans accounted for $6,422,058 of the $54.7 million total tax liability (11.75%). Of this amount, $5,137,646 (80%) was distributed back to the local governments in lieu of the tax formerly levied on bank shares. This information is shown in Table 4.

Table 4

Financial Institutions
FY92

Total Tax Paid	$6,422,058
Refunded to Counties (80%)	$5,137,646

As shown in Table 5, audit collections totaled $15,316,981 during fiscal year 1992. Field audits collected $13,176,212 while office audits brought in $2,140,769.

Table 5

Audit Collections
FY92

Office Audits	$2,140,769
Field Audits	$13,176,212
Total	$15,316,981

CORPORATIONS ELECTING WATER'S EDGE

Multi-national corporations are allowed to elect water's edge treatment for corporation license tax purposes in Montana. This election basically excludes a corporation's foreign income from the base used to calculate its Montana taxable income. If electing water's edge treatment, a corporation must use this method for a minimum of three years. Under water's edge treatment, the tax rate is increased to 7.0% of taxable income, however, taking the election usually results in a tax savings for the corporation. The Department recently conducted an analysis of the total tax impact of water's edge treatment which determined that over the last three years there has been a revenue loss of approximately $4.8 million associated with water's edge elections. The impacts and number of electors by year are shown in Table 6.

Table 6

Tax Loss Due to Water's Edge Elections

Year	Tax Loss	# of Electors
1988	$1,141,251	5
1989	$2,352,802	12
1990	$1,320,386	20

MINIMUM TAX

Montana requires all regular corporations to pay a minimum tax of $50 and small business corporations (IRS S-corps) to pay a (minimum) tax of $10. A state-by-state comparison of minimum taxes is contained in Table 7. In both regular and S-corp minimum taxes, there are six states with a higher tax, one state with the same tax, and four states with a lower tax.

During fiscal year 1992, there were approximately 9,500 corporations paying the $50 minimum tax for a total liability of $475,000. Small business corporations (IRS S-corps) pay a flat $10 tax. During fiscal year 1992, 6,556 S-corporations paid approximately $66,000 via the flat tax.

Table 7

Comparison of Minimum Taxes

State	Regular Corps	S-corps
California	$800	$800
Massachusetts	$456	exempt
Connecticut	$250	$250
Vermont	$150	$150
District of Col.	$100	$100
Utah	$100	exempt
Arizona	$50	exempt
Montana	$50	$10
New Jersey	$25	$25
Idaho	$20	$20
Oregon	$10	exempt
Tennessee	$10	$10

Source: All States Tax Guide.

GRADUATED RATE TAX OPTIONS

Table 8 on the following page summarizes the impacts and structures of several graduated rate license tax options. Options 1 and 2 both have a 2% - 4% - 6% - 8% bracket structure with Option 1 being revenue neutral and Option 2 raising approximately $5 million. Options 3 and 4 both have a 3% - 6% - 9% bracket structure with Option 3 being revenue neutral and Option 4 raising approximately $10 million in revenue. All options assume the distribution of taxable income by corporation is the same as in fiscal year 1992.

Table 8

Options for a Graduated Rate Corporation License Tax

Regular Corporations – Fiscal Year 1992

Option #1 – Revenue Neutral

Montana Taxable Income Brackets	Tax Rate	Tax	Number of Corporations
0 – 25,000	2.00%	650,132	12,918
25,001 – 250,000	4.00%	4,659,165	2,039
250,001 – 450,000	6.00%	3,429,720	251
450,001 & above	8.00%	45,547,282	293
		54,286,299	15,501

Option #2 – $5 million Revenue Increase

Montana Taxable Income Brackets	Tax Rate	Tax	Number of Corporations
0 – 15,000	2.00%	370,118	12,165
15,001 – 30,000	4.00%	904,112	1,074
30,001 – 40,000	6.00%	859,497	412
40,001 & above	8.00%	57,604,408	1,850
		59,738,135	15,501

Option #3 – Revenue Neutral

Montana Taxable Income Brackets	Tax Rate	Tax	Number of Corporations
0 – 250,000	3.00%	4,446,114	14,957
250,001 – 1,500,000	6.00%	12,496,285	478
1,500,001 & above	9.00%	37,640,845	66
		54,583,244	15,501

Option #4 – $10 Million Revenue Increase

Montana Taxable Income Brackets	Tax Rate	Tax	Number of Corporations
0 – 25,000	3.00%	951,740	12,918
25,001 – 150,000	6.00%	6,988,747	2,039
150,001 & above	9.00%	56,385,273	544
		64,325,760	15,501

Analysis of the MACo Tax Reform Proposal : Impact to Montana's Property Tax System

A Report to the Revenue Oversight Committee
of the Montana Legislature

September 25, 1992

Prepared by:

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Helena, Montana

MACo Tax Reform Proposal

This tax reform package proposed by MACo is a comprehensive tax reform proposal. It contains major changes to the property tax system in Montana. The result is significant property tax reduction and shifting of the property tax base. To offset the reduction in property tax collections, the proposal includes revenue replacement options. While this report lists the revenue replacement options, the emphasis of the report is on the impact of the proposal to the current property tax system.

Major Points of the Proposal

Property Tax Changes:

•) All Property Taxed at 100% of Market Value

The tax rate for all property would be 100% of market value. Special exceptions to this would be agricultural land and net proceeds of mines. Agricultural land would be taxed at 100% of productive capacity of the land.

•) Homestead Relief for Homeowners

A homestead relief program would exempt from taxation 65% of the first $50,000 of the market value of owner occupied, single family residences and mobile homes.

•) Eliminate Local Permissive School Levies

The proposal retains the 40 mill statewide equalization levy and the 55 mill school foundation levy but eliminates local permissive school mills. A narrow permissive levy authority for programs unique to a district (subject to voter approval) is allowed.

Revenue Replacement Options:

Option A) Initiate Revenue Increases from Existing Sources

- Cap deduction for federal income taxes paid.
- Eliminate income tax indexing.
- Eliminate income tax exemption for retirement income.
- A surcharge on individual and corporate income tax.
- Increase the coal severance tax rate.
- Reinstate net and gross proceeds taxes.
- Reinstate business inventory tax.
- Return to pre–1989 business equipment tax rates.

Option B) Establish an Entirely New Revenue Source

- Enact a 4% tax on the sale of goods and services.
- Any other revenue source the legislature may determine to be appropriate.

Methodology of Analysis

This report summarizes the estimated impact of the proposal to the current property tax system in Montana.

- •) All taxable value and taxes paid figures are based on tax year 1991 property values and mill levies.
- •) Taxes paid figures are taxes paid for state, county, school, and city/town purposes. The figures do not include taxes paid for miscellaneous and special improvement districts. (Inclusion of miscellaneous and special improvement districts in the analysis would not change the big picture of the proposal).
- •) It is assumed that property tax revenue of taxing jurisdictions (except for local school permissive levies) would remain at tax year 1991 levels.
- •) The analysis is based on the Report of MACo Taxation and Finance Committee Tax Proposal and Analysis, June 1992.
- •) The analysis estimates the impact of the proposal to property groups. Property is grouped as following:

Residential

- Residential Land and Improvements
- Farmstead Land and Improvements
- Mobile Homes

Business Equipment

- Manufacturing and Mining Machinery
- Furniture and Fixtures
- Vehicles
- Ag Implements
- Oil and Gas Field Equipment
- Broadcasting Equipment
- Air and Water Pollution Control Equipment
- Aluminum Electrolytic Equipment
- All Other Business Equipment

Commercial Real

- Commercial Land and Improvements
- Industrial Land and Improvements

Utilities

- Gas and Electric Companies
- Telecommunications Companies
- Pipelines
- Rural Co–ops

Proceeds

- Net Proceeds of Miscellaneous Mines
- Gross Proceeds of Metal Mines

Estimated Impacts to the Property Tax System

The proposal impacts the property tax system in two major areas:

•) Over $185,000,000 in Property Tax Reduction

This is the most obvious impact of the proposal. The reduction is the result of eliminating local permissive school levies. The $185 Million in property tax reduction represents 1/3 of current property taxes collected for state, county, school, and city/town purposes.

•) Significant Shifting of the Property Tax Base

This is the most important impact of the proposal. It is important for two reasons;

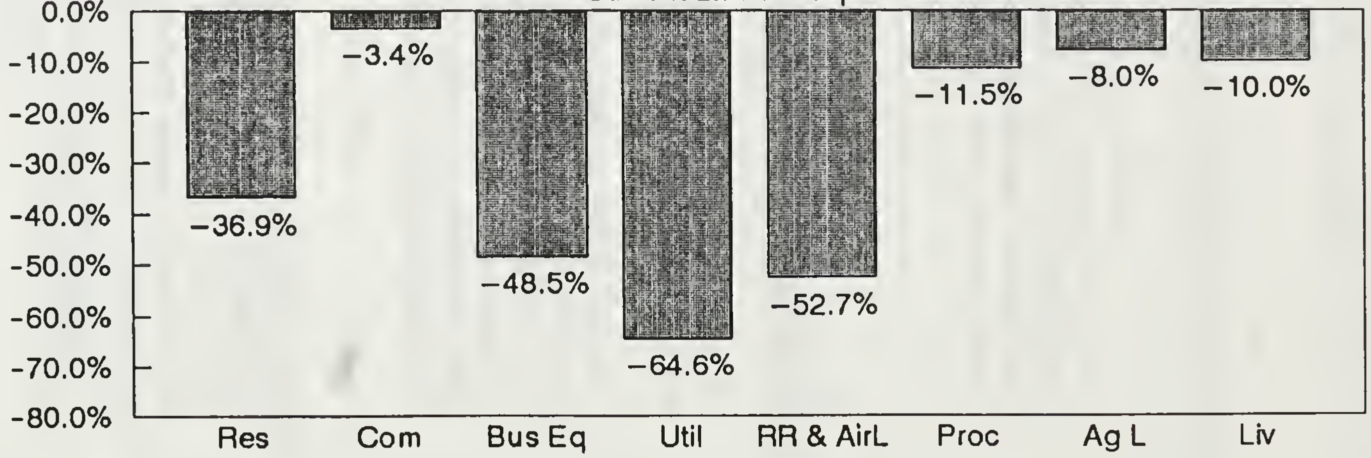
1) The shift in the tax base will determine the distribution of the $185,000,000 in property tax reduction. Overall, all property groups will pay fewer property tax dollars under the proposal. But some property groups will see larger savings than others. Largest savings go to utilities (64% decrease in property taxes paid) and railroads (53% decrease). Smallest savings go to commercial real property (3% decrease).

2) The shift in the tax base will determine the burden of future property tax collections. The tax burden of some property groups will increase, while others will realize a decrease. The commercial real property tax burden increases from the current 14.5% share to a 22.2% share of the total property tax burden. Conversely, the burden for utilities decreases from a current 20.4% share to 11.4% share of the total property tax burden.

Change in Property Taxes Paid
Current Law vs. Proposal

Property Group	Property Taxes Paid Current	Proposal	Change	Percent Change
Residential	183,672,331	115,979,835	(67,692,496)	−36.9%
Commercial Real	73,593,652	71,092,087	(2,501,565)	−3.4%
Business Equip.	73,858,459	38,059,296	(35,799,163)	−48.5%
Utilities	103,112,627	36,547,517	(66,565,110)	−64.6%
Railroads & Airlines	15,960,941	7,555,769	(8,405,172)	−52.7%
Proceeds	6,141,941	5,434,184	(707,757)	−11.5%
Ag Land	42,124,912	38,737,649	(3,387,263)	−8.0%
Livestock	7,681,615	6,912,732	(768,883)	−10.0%
Statewide Total	506,146,478	320,319,069	(185,827,409)	−36.7%

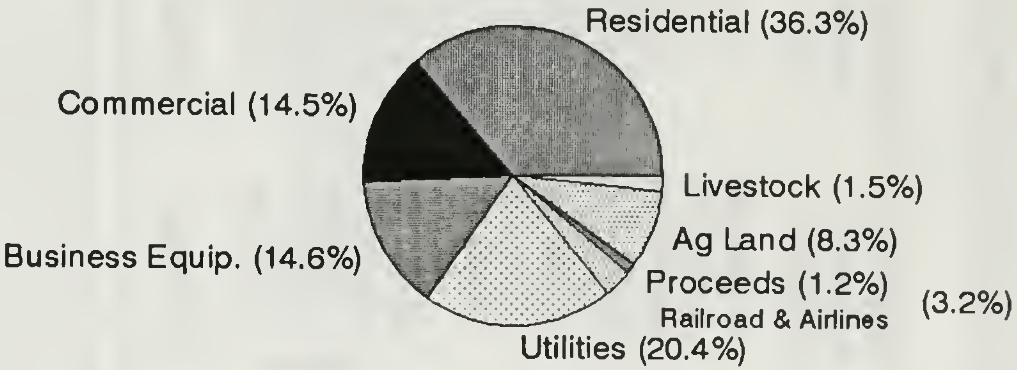
Change in Property Taxes Paid
Current Law to Proposal



Comparison of Share of Total Property Tax Dollars Paid
Distribution of Tax Liability by Property Type

	Current	
Property Group	Property Tax Paid	Share
Residential	183,672,331	36.3%
Commercial Real	73,593,652	14.5%
Business Equip.	73,858,459	14.6%
Utilities	103,112,627	20.4%
Railroads & Airlines	15,960,941	3.2%
Proceeds	6,141,941	1.2%
Ag Land	42,124,912	8.3%
Livestock	7,681,615	1.5%
Statewide Total	506,146,478	100.0%

Current Law



	Proposal	
Property Group	Property Tax Paid	Share
Residential	115,979,835	36.2%
Commercial Real	71,092,087	22.2%
Business Equip.	38,059,296	11.9%
Utilities	36,547,517	11.4%
Railroads & Airlines	7,555,769	2.4%
Proceeds	5,434,184	1.7%
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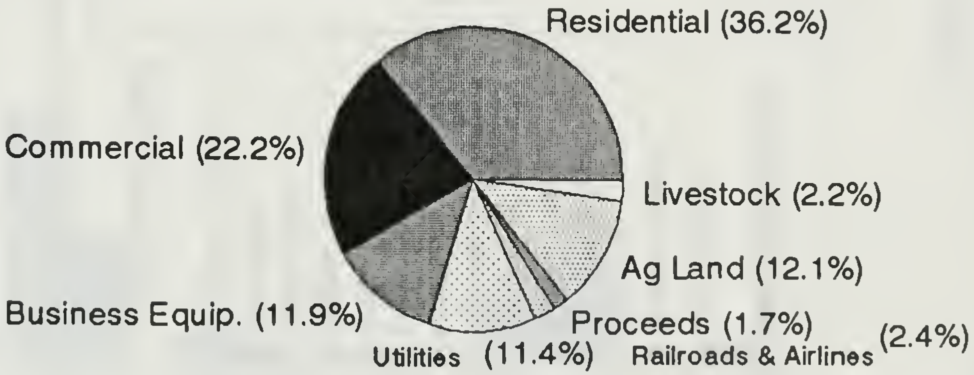
Statewide Total	320,319,069	100.0%

MACO Proposal



MACO Property Tax Proposal

Impact to Tax Revenue Paid by Property Class

Tax Year 1992 Classes	Estimated Current Revenue	Estimated Proposed Revenue	Change in Property Tax	Percent Change in Property Tax
1 Net Proceeds	2,189,354	1,052,895	(1,136,459)	−51.9%
2 Gross Proceeds	3,952,586	4,381,288	428,702	10.8%
3 Ag Land	39,990,912	36,960,043	(3,030,870)	−7.6%
4 Residential Real	161,293,552	98,790,067	(62,503,485)	−38.8%
4 Mobile Homes	5,137,426	3,104,011	(2,033,415)	−39.6%
4 Commercial Real	73,520,664	70,986,082	(2,534,583)	−3.4%
5 Co−ops, Poll. Control	6,189,763	8,197,564	2,007,801	32.4%
6 Livestock	8,516,398	7,770,190	(746,208)	−8.8%
7 Independent Teleph.	268,146	116,932	(151,213)	−56.4%
8 Business Equipment	69,776,374	32,569,257	(37,207,117)	−53.3%
9 Utilities	99,936,314	32,912,512	(67,023,803)	−67.1%
10 Timber Land	2,137,880	1,778,080	(359,799)	−16.8%
11 Farmsteads	17,276,165	14,144,377	(3,131,788)	−18.1%
12 Railroads & Airlines	15,960,941	7,555,769	(8,405,172)	−52.7%
Statewide Total	506,146,478	320,319,069	(185,827,409)	−36.7%

Impact to Tax Revenue Paid by Property Group

Property Group	Estimated Current Revenue	Estimated Proposed Revenue	Change in Property Tax	Percent Change in Property Tax
Residential	183,672,331	115,979,835	(67,692,496)	−36.9%
Commercial Real	73,593,652	71,092,087	(2,501,565)	−3.4%
Business Equipment	73,858,459	38,059,295	(35,799,163)	−48.5%
Utilities	103,112,627	36,547,517	(66,565,110)	−64.6%
Railroads & Airlines	15,960,941	7,555,769	(8,405,172)	−52.7%
Proceeds	6,141,941	5,434,184	(707,757)	−11.5%
Agricultural Land	42,124,912	38,737,649	(3,387,263)	−8.0%
Livestock	7,681,615	6,912,732	(768,883)	−10.0%
Statewide Total	506,146,478	320,319,069	(185,827,409)	−36.7%

Compiled by the Office of Research and Information, Montana Department of Revenue.
Based on Tax Year 1991 Taxable Values and Tax Year 1991 Mill Levies.

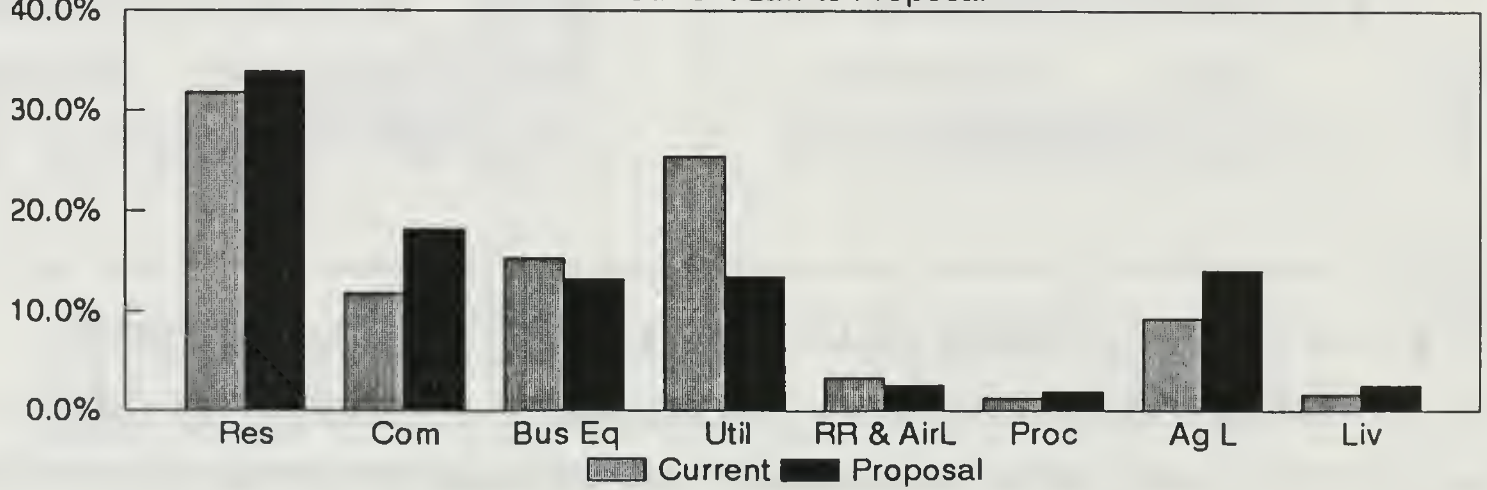
24−Sep−92

Shift in Property Tax Base Share
Current Law vs. Proposal

Property Group	Property Tax Base Share Current	Proposal	Percent Change
Residential	31.8%	33.9%	6.4%
Commercial Real	11.8%	18.1%	53.7%
Business Equip.	15.3%	13.3%	−13.0%
Utilities	25.5%	13.5%	−47.1%
Railroads & Airlines	3.4%	2.6%	−21.6%
Proceeds	1.3%	1.9%	46.0%
Ag Land	9.3%	14.2%	52.9%
Livestock	1.7%	2.5%	47.8%
Statewide Total	100.0%	100.0%	

Change in Property Tax Base Share

Current Law to Proposal



Shift of Share of Statewide Total Taxable Value
Burden Per $1,000 of Property Taxes Levied

Property Group	Current		Proposal	
	Taxable Values	Share	Taxable Values	Share
Residential	507,754,568	31.8%	9,138,992,976	33.9%
Commercial Real	188,144,068	11.8%	4,893,030,212	18.1%
Business Equip.	243,541,622	15.3%	3,582,902,374	13.3%
Utilities	406,125,673	25.5%	3,637,130,887	13.5%
Railroads & Airlines	53,593,331	3.4%	710,786,886	2.6%
Proceeds	20,549,016	1.3%	507,508,405	1.9%
Ag Land	148,216,272	9.3%	3,832,799,004	14.2%
Livestock	27,296,910	1.7%	682,422,746	2.5%
Statewide Total	1,595,221,460	100.0%	26,985,573,490	100.0%

Property Group	Burden for $1,000 of Property Taxes Levied			
	Current	Proposal	Change	% Change
Residential	$318	$339	$20	6.4%
Commercial Real	118	181	$63	53.7%
Business Equip.	153	133	($20)	−13.0%
Utilities	255	135	($120)	−47.1%
Railroads & Airlines	34	26	($7)	−21.6%
Proceeds	13	19	$6	46.0%
Ag Land	93	142	$49	52.9%
Livestock	17	25	$8	47.8%
Statewide Total	$1,000	$1,000	$0	

MACO Property Tax Proposal

Share of Statewide Property Tax Base

Tax Year 1992 Classes	Current		Proposed		Change in Tax Base Share
	Taxable Value	Percent of Statewide Total	Taxable Value	Percent of Statewide Total	
1 Net Proceeds	8,318,381	0.5%	99,820,572	0.4%	−29.1%
2 Gross Proceeds	12,230,635	0.8%	407,687,833	1.5%	97.0%
3 Ag Land	141,558,901	8.9%	3,666,104,620	13.6%	53.1%
4 Residential Real	433,587,219	27.2%	7,484,951,356	27.7%	2.0%
4 Mobile Homes	15,274,132	1.0%	262,677,583	1.0%	1.7%
4 Commercial Real	187,850,983	11.8%	4,881,794,018	18.1%	53.6%
5 Co−ops, Poll. Control	27,333,101	1.7%	911,103,372	3.4%	97.0%
6 Livestock	29,705,017	1.9%	755,402,522	2.8%	50.3%
7 Independent Teleph.	885,909	0.1%	11,073,863	0.0%	−26.1%
8 Business Equipment	223,882,855	14.0%	2,936,180,232	10.9%	−22.5%
9 Utilities	395,328,590	24.8%	3,294,404,919	12.2%	−50.7%
10 Timber Land	6,669,376	0.4%	166,734,400	0.6%	47.8%
11 Farmsteads	59,003,031	3.7%	1,396,851,314	5.2%	39.9%
12 Railroads & Airlines	53,593,331	3.4%	710,786,886	2.6%	−21.6%
Statewide Total	1,595,221,460	100.0%	26,985,573,491	100.0%	

Share of Statewide Property Tax Base

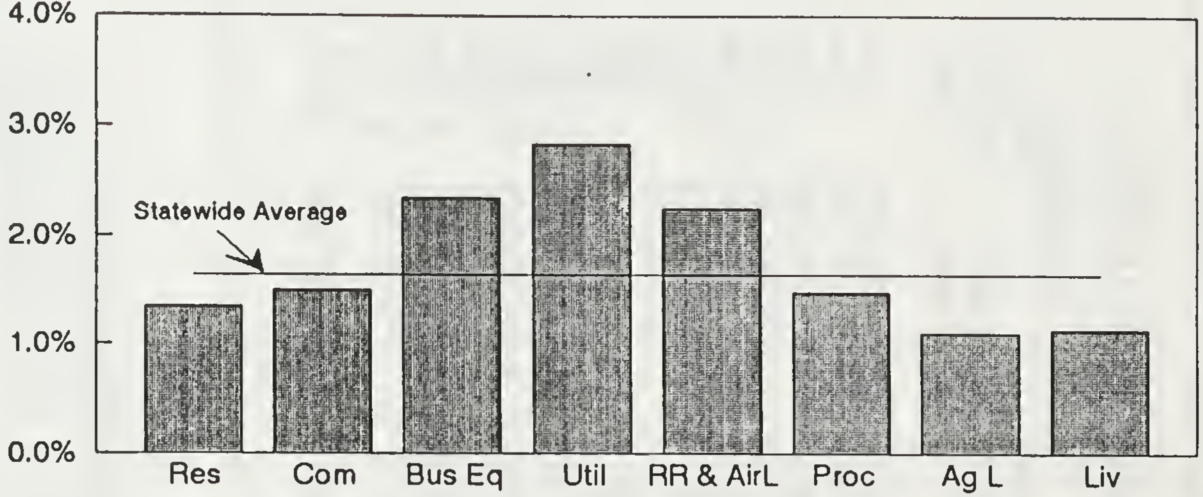
Property Group	Current		Proposed		Change in Tax Base Share
	Taxable Value	Percent of Statewide Total	Taxable Value	Percent of Statewide Total	
Residential	507,754,568	31.8%	9,138,992,976	33.9%	6.4%
Commercial Real	188,144,068	11.8%	4,893,030,212	18.1%	53.7%
Business Equipment	243,541,622	15.3%	3,582,902,375	13.3%	−13.0%
Utilities	406,125,673	25.5%	3,637,130,887	13.5%	−47.1%
Railroads & Airlines	53,593,331	3.4%	710,786,886	2.6%	−21.6%
Proceeds	20,549,016	1.3%	507,508,405	1.9%	46.0%
Agricultural Land	148,216,272	9.3%	3,832,799,004	14.2%	52.9%
Livestock	27,296,910	1.7%	682,422,746	2.5%	47.8%
Statewide Total	1,595,221,460	100.0%	26,985,573,491	100.0%	

Compiled by the Office of Research and Information, Montana Department of Revenue.
Based on Tax Year 1991 Taxable Values and Tax Year 1991 Mill Levies.

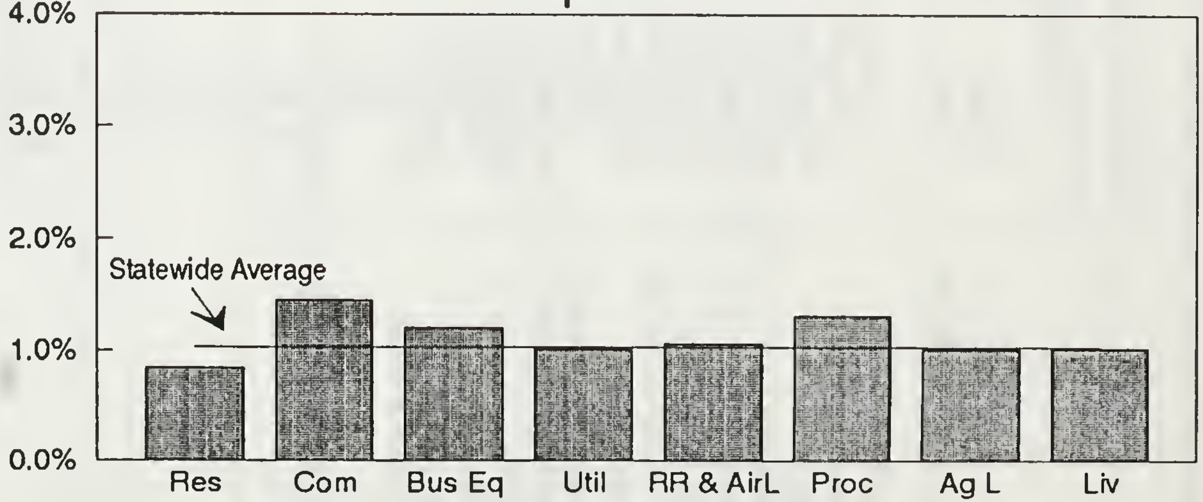
24−Sep−92

Comparison of Effective Tax Rate (Taxes Paid/ Assessed Value)
Current Law vs. Proposal

	Current Effective Tax Rate
Residential	1.35%
Commercial Real	1.50%
Business Equip.	2.34%
Utilities	2.84%
Railroads & Airlines	2.25%
Proceeds	1.48%
Ag Land	1.10%
Livestock	1.14%
Statewide Avg	1.63%


Current Law

	Proposal Effective Tax Rate
Residential	0.85%
Commercial Real	1.45%
Business Equip.	1.21%
Utilities	1.01%
Railroads & Airlines	1.06%
Proceeds	1.31%
Ag Land	1.01%
Livestock	1.02%
Statewide Avg	1.03%


Proposed Law

Impact to Mill Levies

	Current	Proposed	Difference
Education			
– Universities	6.000	0.355	–5.645
– State Equalization Levy	40.000	2.365	–37.635
– County Equalization Levies	55.000	3.250	–51.750
– Local Permissive Levies *	116.490	0.000	–116.490
County Government **	70.813	4.185	–66.628
City/Town Government **	98.633	5.698	–92.935
TOTAL	386.935	15.853	–371.082

* The mill levy value listed is a statewide average of local permissive levies. The MACO proposal allows for a narrow permissive levy authority for programs unique to a district tied to a vote of the people.

** The mill levy values listed are statewide averages.

Impact to Property Tax Revenues

	Current	Proposed	Difference
Education			
– Universities	9,571,329	9,571,329	0
– State Equalization Levy	63,808,858	63,808,858	0
– County Equalization Levies	87,737,180	87,737,180	0
– Local Permissive Levies *	185,827,410	0	(185,827,410)
County Government **	112,961,669	112,961,669	0
City/Town Government **	46,290,678	46,290,678	0
	506,197,124	320,369,714	(185,827,410)

* The mill levy value listed is a statewide average of local permissive levies. The MACO proposal allows for a narrow permissive levy authority for programs unique to a district tied to a vote of the people.

** The mill levy values listed are statewide averages.

THE VALUE-ADDED TAX:

AN ALTERNATIVE APPROACH TO COMPREHENSIVE TAX REFORM IN MONTANA

Office of Research and Information
Montana Department of Revenue

September, 1992

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The Value-Added Tax: An Alternative Approach to Comprehensive Tax Reform in Montana

Introduction - The Need for Tax Reform in Montana

Comprehensive tax reform has been a major issue facing the state of Montana for the past six years. The need for comprehensive tax reform stems from three different sources: a mandate from the electorate, a deteriorating fiscal system, and a perceived poor business climate.

Initiative 105

In 1986, the electorate, disgruntled with rapidly escalating property taxes and the perception of inordinately high property tax burdens, passed Initiative 105 (I-105). That initiative provided that property taxes were to be frozen at their 1986 level until such time as the legislature provided for comprehensive tax reform designed to reduce property tax burdens, while at the same time providing revenue sufficient to fund future state and local government needs.

Structural Deficit

More recently, the state legislature has been struggling to find an appropriate means of funding an ever growing structural state deficit. In 6 of the past 9 years, state general fund and school equalization account revenues have failed to keep pace with spending, notwithstanding several across-the-board spending reductions initiated by current and past administrations and legislatures.[1] Revenue shortages have forced two special legislative sessions in 1992 alone. Recent estimates have placed the state's structural deficit as high as $200 - 350 million by July 1, 1995.[2] Contributing to this deficit situation is the fact that revenues from natural resource taxes, Montana's "third leg" of the tax stool, have dropped from $244.4 million in fiscal year 1985 to $136.8 million in fiscal year 1992.

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[1] The Montana Historical Revenue and Expenditure Report, Fiscal Years 1979 through 1991, Office of the Legislative Fiscal Analyst, June, 1992.

[2] Appropriations Report, 1993 Biennium, July 1992 Special Session, Office of the Legislative Fiscal Analyst, July, 1992.

Business Climate

The state's current tax structure is often cited as one of the principal reasons why the state consistently receives low marks in studies and surveys ranking state business climates. Montana is often ranked among the worst states in this regard. Particularly troublesome to analysts of state business climates are Montana's absence of a general retail sales tax, the relatively high tax rates on business personal property, and the relatively high top marginal income tax rate.

Past and Current Comprehensive Tax Reform Proposals

All of the past and current proposals for comprehensive tax reform that have received serious attention by the legislature attempt to rectify Montana's fiscal dilemma through a combination of property tax and income tax relief, funded through the enactment of a general retail sales tax. Proposals of this nature have been discussed extensively since the 1987 Legislative Session. Indeed, in this election year both the Republican and Democratic gubernatorial candidates have endorsed a general sales tax as the means by which to provide comprehensive tax reform, and additional revenue to fund the needs of state and local governments.

Invariably, however, reform proposals that rely on a general sales tax include provisions requiring final approval of the tax through the referendum process. Historically, proposals for a general sales tax that have been voted on by the electorate have met with failure in Montana. While there is speculation that a greater number of voters recognize the need for a general sales tax in Montana, there remains the possibility that such a referendum would not be approved.

There has been little in the way of alternative proposals for comprehensive reform in the absence of a general sales tax. It is unlikely that existing taxes could be raised enough to fund the structural deficit. After all, one of the overriding purposes of comprehensive tax reform is to provide relief in current income and property taxes. In addition, the current depressed economic climate in the natural resources industries makes it unlikely that taxes could be raised significantly in this sector. Few alternatives seem available.

Which brings us to the subject of this paper--the implementation of a value-added tax in Montana as an alternative solution for comprehensive tax reform.

What is the Value-Added Concept?

A value-added tax (VAT) is a single, flat-rate tax that is applied to all business activity within a taxing jurisdiction, regardless of whether the form of ownership is a corporation, partnership, or sole proprietorship. All forms of businesses are taxed on the basis of the value that they add to the economy.

Generally, value-added taxation has been used only at the national level, most notably by member nations of the European Economic Community (EEC). But this type of tax is also gaining widespread use in developing nations, and is also used in Mexico. Currently, Michigan is the only state that has adopted a value-added tax (the Michigan Single Business Tax), but this tax either has been or currently is being considered by other states including Florida, Minnesota, Texas, Georgia, Oregon, Indiana, and California. In 1970, the VAT was passed by both houses of the West Virginia Legislature, but was vetoed by the governor.

Because the tax applies to all business activity, the tax base is very large, relative to other forms of taxation, which allows for a relatively low tax rate. In fact, one type of value-added tax has the same theoretical tax base as the general retail sales tax, as is discussed below.

How is Value Added Measured by the Individual Firm?

For an individual firm, value added can be thought of as the difference between what the firm receives in revenue when it sells it's product(s), and what it costs that firm to purchase the materials (or goods and services) that went into producing that product. This difference is the "value added" by the production process.

In accounting terms, value added may be represented as follows:

Value Added = Revenue - Cost of Materials

Similarly, total revenue for a firm, by definition, is equal to the cost of the materials that went into producing the goods, the cost of labor, depreciation and interest (the cost of capital), and profit:

Revenue = Cost of Materials + Cost of Labor + Depreciation + Interest + Profit

By substituting the second equation above into the first, value added can also be stated as follows:

Value Added = Cost of Labor + Depreciation + Interest + Profits

Under the value-added tax concept, each individual firm would compute its value added as its tax base, and apply the tax rate to that value to determine tax liability.

Subtraction, Addition, and Credit Methods

The above equations illustrate the *subtraction* and the *addition methods* of calculating the VAT tax base for an individual firm. Under the subtraction method the costs of materials purchased from other firms is subtracted from total revenue. In practice, deductible costs include all purchases from other firms including items such as electricity and other utilities, advertising, insurance, travel, repairs, freight and postage, and supplies, as well as the cost of any physical materials used in the construction or processing of the product.

Under the addition method, all of the payments to the firm's factors of production are added to arrive at the tax base. As noted above this includes wages and salaries, interest paid to creditors, depreciation, and the return of profits to the owners of capital. In addition, it should be noted that payments to labor include all fringe benefit payments, and payroll taxes for unemployment compensation and workmen's compensation, as these also reflect payments to the factors of production, which add value to the product.

The important feature to notice regarding these two methods is that both methods result in the same tax base.

A third method, employed by the members of the EEC, is the *credit method*, often referred to as the invoice method. Under this method, the VAT is levied on the gross receipts from all sales made by each firm in the commercial chain. Credits against this liability are then allowed to the extent shown as VAT liabilities of suppliers to the firm, as evidenced on invoices of the firms purchases.

In other words, every seller in the commercial chain collects the tax from the buyer and remits it to the state. The buyer then collects the tax on subsequent sales, and is allowed a credit for the taxes paid to the previous seller. The ultimate consumer is not entitled to a credit, and, in theory, bears the entire burden of the tax.

This method results in the same tax liability as the addition or subtraction method, but has the added feature of built-in compliance on the part of the taxpayer.

Measuring Aggregate Value Added--Gross Product, Income, and Consumption Types of VAT

In a national economy value added may be measured as the sum of payments made to the factors of production--land, labor, and capital. The aggregate tax base of a value-added tax is best illustrated at the national level, because of the close relationship between VAT tax bases and the National Income and Product Accounts (NIPA).

At the national level there are three types of value-added taxes:

- the **gross product type**, the tax base of which corresponds to gross national product;
- the **income type**, where the tax base corresponds to national income; and
- the **consumption type**, where the tax base corresponds to personal consumption expenditures.

The difference in these bases lies in the different treatment of capital acquisitions under each type of VAT.

Under the gross product type of VAT, firms are not allowed to deduct either the cost or depreciation associated with capital goods. The income variant of the tax allows depreciation to be deducted, whereas the consumption type of VAT allows a full deduction for the cost of capital purchases in the year they are made.

Origin-Based vs. Destination-Based VATs

When contemplating value-added taxes, it is necessary to distinguish between a tax that is based on the destination principle, and that which is based on the origin principle.

Under the **origin-based** principle of taxation, the tax is applied to production within the taxing jurisdiction, regardless of where final consumption of the output of producing firms occurs. As such, taxes apply to exports, but not to imports, and benefit the taxing jurisdiction in which the economic activity takes place.

Under the **destination-based** principle, exports would be exempt from taxation while imports would be subject to the tax. This principle of taxation tends to place the burden of taxation on consumption in the taxing jurisdiction and benefits the taxing jurisdiction in which the consumption takes place. General retail sales taxes are based on the destination (consumption) principle, as are the VATs currently in use in the European nations.

Which Value-Added Tax is Best for States?

The above discussion has shown that a value-added tax may be of the gross product, income, or consumption type; may use either the addition, subtraction, or credit methods; and may be origin-based or destination-based. These combinations allow for 18 different types of VAT. Which is the best for state use?

First, gross product types of VAT are rarely given serious consideration for good reason. The gross product type of VAT represents not only a tax on all personal consumption--goods and services--but also a tax on business gross investment. Taxing business capital investment in this manner provides a significant disincentive for investment, and is counter to the goal of enhancing a taxing jurisdiction's business climate. Also, disallowing both a capital expenditure deduction and any subsequent depreciation results in taxing the value of capital equipment twice--once in the sales of the capital goods producer, and second in the tax base of the purchaser (who is not allowed a capital acquisition deduction).

Second, both destination-based VATs and the credit method of determining the tax base are features that are typically applied in international VAT schemes, and do not lend themselves to state use of the VAT. (See *The Fourth Report of the Special Committee on the Value-Added Tax of the Section of Taxation*, American Bar Association, for a detailed discussion of why destination-based VATs and the credit method are inappropriate for state use.)

This reduces the appropriate choices at the state level to origin-based VATs, of the income or consumption type, that use either the addition or subtraction method to calculate the tax base.

Addition vs. Subtraction Methods

As discussed earlier, under the subtraction method the firm deducts the costs of its purchases from its sales to determine value added. Under the addition method payments to the various factors of production--profits, compensation, interest and rent, and depreciation--are added together to determine value added. While both methods theoretically arrive at the same tax base, practical considerations may favor the addition method.

First, the addition method allows federal taxable income, as an approximate measure of profit, as the starting point in computing value added. This is the same starting point currently in use by corporations when calculating Montana corporation income taxes. Tying to this federal starting point facilitates preparation and administration of taxes for state tax purposes.

Second, the addition method makes explicitly clear the different components of the tax base (compensation, profit, etc.), and facilitates comparison of the relative importance of each component in the base.

Treatment of Financial Institutions. Finally, and perhaps most importantly, the addition method is more suitable when applied to financial institutions. When calculating value added under a pure VAT scheme, interest, rent, and royalty *payments* are included in the tax base as payments to factors of production (increases in value added). Interest, rent, and royalty *receipts* are subtracted from the base. (These sources of income, included in federal taxable income, are not generally considered a part of the firm's "profit" component and are excluded from the tax base.)

On the other hand, the nature of the business of financial institutions is such that interest payments are really more akin to a cost of the services provided. Use of the addition method easily allows the treatment of interest to be reversed for financial institutions; that is, interest payments are subtracted from the base, while interest receipts are included in the base. One drawback to this approach is that interest payments from financial institutions to nonfinancial businesses escape taxation altogether (as nonfinancial institutions are allowed to deduct interest income from their tax bases).

Treatment of Rent. Another problem arises in the treatment of rent payments and rent income. Should rent be included in the tax base of the lessee (rent received is excluded and rent paid is included), or the lessor (rent received is included and rent paid is excluded)?

A pure VAT would adhere to the first approach; that is, rent should be treated as it is for national income accounts, as a factor payment to be included in the tax base of the renter. One advantage to this approach is that it avoids the potential for significant erosion of the tax base--the lease of real or personal property by tax-exempt nonprofit organizations to taxable for-profit businesses.

Under the second approach rent would be included in the tax base of the lessor of land and equipment. This approach has two advantages. First, this approach prevents a windfall gain for certain segments of the economy; in particular, those types of businesses whose income is primarily from rent, particularly real estate management firms. Second, this approach also prevents penalizing firms that prefer to lease rather than buy property. This is especially true under the consumption type of VAT, where capital purchases are fully deductible in the year of purchase. In this situation, allowing rent paid to be excluded from the base would make the VAT neutral with respect to the firm's decision to either lease or purchase capital goods.

Michigan has adopted the latter treatment of rent in its Single Business Tax. However, either treatment easily could be handled under the addition method of calculating the tax base. A final decision of the appropriate treatment would depend on the relative merits of the advantages and disadvantages inherent in both approaches in the particular state contemplating adoption of a VAT.

Income vs. Consumption Type of VAT

The issue of whether to use the addition or subtraction method is one primarily of administrative ease. On the other hand, the decision to implement either an income or a consumption type VAT is one that involves extremely important policy objectives.

The first objective involves the decision of whether it is the goal of the VAT to tax income or consumption. Recall that the difference between these two types of VAT lies in the treatment of capital purchases. Full deduction for the cost of capital acquisitions results in the taxation of consumption, while an allowance for depreciation only results in the taxation of income.

The income type VAT has as its theoretical tax base the same base as a general, comprehensive income tax. In this regard, implementing an income type VAT is analogous to implementing a proportional (flat-rate) income tax. It is sometimes argued that if the intent is to tax income, then a general overhaul of the corporation and individual income taxes may be more appropriate than implementation of a value-added tax of the income type. This argument applies more to situations where (1) the VAT is intended as a supplement to existing income taxes, or (2) the VAT is intended as a revenue-neutral replacement for income taxes.

The advantages and disadvantages of the income and consumption types of VAT are best discussed in terms of their impact on specific criteria for sound tax policy--**simplicity and ease of administration, stability, revenue generation, and business growth and development.**

Simplicity. A consumption type VAT has the advantage from the standpoint of simplicity and ease of administration. The income type VAT is complicated by the fact that some arbitrary depreciation scheme must be used. Depreciation complicates business tax filings and adds complexity to administration of the tax. This complexity is compounded greatly if the state requires state-specific depreciation schedules that differ from depreciation schedules allowed for federal income tax purposes. Companies would then be required to keep separate books for federal and state tax purposes. Alternatively, if the state were to tie to federal depreciation schedules then complexity is reduced, but at the cost of loss of control as witnessed by the dramatic changes in federal depreciation schedules under the Tax Equity and Fiscal Responsibility Act of 1981 (TEFRA-81), and the Tax Reform Act of 1986 (TRA-86).

In addition, a decision must be made as to whether depreciation will be allowed only for property purchased following implementation of the VAT, or for property purchased prior to implementation as well.

Certain complexities may be encountered with consumption type VATs as well. Companies with extraordinary capital acquisitions may not be able to use all of their capital purchase deduction in a single year. In these cases it may be appropriate to allow the company to carryover these deductions to future tax years until they are fully used. Tracking carryovers complicates tax preparation and administration, but probably not to the extent that depreciation does.

Stability. Revenue stability is essential to the efficient performance of government. Severe swings in revenue may result in inappropriate increases in spending in good years, followed by layoffs or sudden reductions in services in poor years.

With respect to revenue stability, the consumption type VAT suffers from the fact that investment tends to be "lumpy", and may to a large extent be subject to conditions beyond the control of the state--such as federal monetary and fiscal policy. For example, investment is sensitive to fluctuations in interest rates, and to federal tax investment incentives, such as investment tax credits. The use of depreciation in the income type VAT tends to smooth both the lumpiness and the effects of external investment incentives over the life of the investment assets, adding stability to revenue flows.

In one respect, the consumption type VAT has a built-in stabilizer. In times when the economy is booming, additional investment in capital goods will increase deductions allowable under the VAT, thereby acting to temper the increase in revenue flows. When the economy is flat investment falls, which reduces deductions to the tax base and thereby moderates the decline in revenue flows. The effectiveness of this stabilizer is questionable in states such as Montana, where the state economy is often countercyclical to the national economy, and where capital investment is not as frequent as in other more manufacturing-oriented states such as Michigan.

Revenue Generation. If the overriding criterion for implementing a VAT is to increase revenue while maintaining a relatively low tax rate, then the income type VAT is the clear choice, given its significantly larger tax base. A look at the Michigan experience puts this difference into perspective. In 1981, the Michigan Single Business Tax, which is a consumption type VAT, generated $942.2 million in revenue. During that same period, the capital acquisition deduction and its associated carryover provision reduced tax revenue a total of $341.5 million.[3] This represents a 27 percent reduction in revenue attributable to this deduction. Even though this result ignores the offsetting effects of allowing depreciation, it is clear that the capital acquisition deduction reduces the tax base by 20-25% in the Michigan VAT.

Business Climate/Competition. With respect to business climate and interstate tax competition, the consumption type VAT is superior to the income type. The consumption type VAT provides the most neutral treatment of all categories of depreciable property by treating them all the same. Treatment of capital between and within industry groups is the same.

The favorable treatment of capital under the consumption type VAT provides a significant incentive for the formation of capital, and the creation of new jobs. In an analysis of the

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[3] *Analysis of the Michigan Single Business Tax*, Taxation and Economic Policy Office, Michigan Department of Treasury, January, 1985, pp.18, 34.

Michigan value-added tax the Advisory Commission on Intergovernmental Relations (ACIR) noted that proponents of the tax "...argued that the VAT with its capital acquisition deduction would lessen the heavy tax burden on capital, increasing the return on capital investment, thereby making investment in Michigan more attractive, and in turn create new jobs. This objective was given primary emphasis because of the concern about employment opportunities and the genuine belief that this was the major advantage of the switch to the value added tax."[4]

The consumption type VAT is particularly helpful to new and growing firms. The full deduction for capital purchases, particularly when accompanied by carryover provisions, provides tax relief to new firms in the crucial, early years of their development.

As with depreciation, the question arises as to the proper treatment of capital acquired prior to implementing a VAT. A VAT that allows a full deduction only for property acquired subsequent to the implementation date would obviously place companies with large capital purchases prior to implementation at a competitive disadvantage with companies making similar acquisitions after implementation.

In general, the choice between a consumption type VAT or an income type VAT will depend on the perceived necessity for meeting competing state tax policy objectives. Policymakers who feel that simplicity, ease of administration, capital formation, and business climate are top priorities will be inclined towards the consumption type of VAT. If priorities include stability of revenue flows, additional revenue generation, and a broad tax base that allows a reduced tax rate, then the income type of VAT would appear favorable.

When the choice is limited to implementing either a consumption type VAT or an income type VAT, with no other changes in the tax structure, the consumption type VAT clearly provides a greater incentive for capital formation. But within the context of *comprehensive* tax reform policymakers have a wide variety of policy options from which to chose. It's possible to provide just as great an incentive for economic development through a combination of implementing an income type VAT coupled with a reduction in the current personal property tax rate on business equipment by, say, two-thirds. The reduction in property tax rates could be funded out of the larger tax base associated with the income type VAT. This approach serves the dual purpose of dramatically reducing one of Montana's more offensive tax rates, while maintaining a stable broad-based VAT with a lower rate.

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[4] *The Michigan Single Business Tax: A Different Approach to State Business Taxation*, ACIR, March, 1978, p. 20.

How Much Revenue Would a VAT Raise in Montana?

The amount of revenue that a value-added tax would raise in Montana will depend on several factors, including the type of VAT implemented (income or consumption), the tax rate, and any special exemptions, credits, or other provisons that act to reduce the base.

Unfortunately, at this time data on corporations, partnerships, and sole proprietorships needed to provide an estimate of the revenue from a VAT is not available. Nevertheless, it is possible to provide rough estimates of the revenue generating potential from a VAT by examinimg the state-level theoretical tax base associated with a VAT, and by comparing the Montana economic base with that of Michigan.

At the national level the theoretical tax bases associated with the gross product, income, and consumption types of VAT are gross national product, national income, and personal consumption expenditures. The following table shows the relationship between these tax bases, as reported in the National Income and Product Accounts:[5]

Table 1
Relationship Between National Theoretical VAT Tax Bases
($ billions)

VAT Type	Theoretical Tax Base	1990	1991
Gross Product	Gross National Product	5,542.9	5,694.9
Income	National Income	4,468.3	4,544.2
Consumption	Personal Consumption Expenditures	3,748.4	3,887.7

The above table illustrates a couple of points. First, at the national level in 1991 a consumption type VAT would have raised about $39 billion for each 1 percent levied on the theoretical base. In practice, however, it is virtually impossible to tax the entire theoretical tax base. First, much of the value included in personal consumption expenditures (PCE) is difficult to tax due to valuation, enforcement, and overly burdensome bookkeeping problems. Enforcement and compliance problems abound in the value-added taxation of very small businesses and value added by "moonlighting" tradespeople and professionals. PCE also includes the imputed value of owner-occupied housing, which is difficult to measure. Also included in PCE are the value of state and local government services, and charitable and religious organizations, activities that are generally exempt from taxation.

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[5] *Survey of Current Business*, U.S. Dept. of Commerce, (72/7), July, 1992, pp. 52, 57.

Second, it is generally recognized that "merit" goods would go untaxed under a national VAT scheme. Merit goods include those goods and services that are considered beneficial to society, and include education, research, health care, and welfare services.

Finally, because VATs are generally recognized as being "regressive" taxes, there is considerable pressure to exempt from tax items suh as food consumed at home, household utilities, gas and oil, and housing purchases other than new homes.

The Congressional Budget Office has estimated that administrative difficulties could reduce the tax base by up to 25 percent; exempting merit goods could reduce the base an additional 14 percent; and addressing the regressivity issue could reduce the base further by up to 23 percent, for a total reduction in the national base of 62 percent.[6]

At the state level, it is possible to obtain rough estimates of the revenue generating potential from a state VAT by examining state counterparts to the national income accounts. Estimates of state gross product are available, as are estimates of personal consumption expenditures. Because gross product types of VATs are rarely considered, only the personal consumption base is explored here.

Table 2 shows Montana disposable personal income, and an estimate of personal consumption expenditures, for the 1989 - 1991 period. The factor used to convert personal income to disposable personal income is the national factor in each year.

Table 2
Theoretical Montana Consumption Type VAT Base
($ millions)

	1989	1990	1991
Disposable Personal Income	9,848	10,177	11,100
Personal Consumption Factor	.93	.93	.92
Personal Consumption Expenditures	9,159	9,465	10,212
Revenue from 1% VAT	91.59	94.65	102.12
Revenue from 4% VAT	366.35	378.58	408.48
Revenue, Net of 62% Erosion	139.21	143.86	155.22

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[6] *Effects of Adopting a Value-Added Tax*, Congressional Budget Office, February, 1992, pp. 21-26.

In 1990, revenue from a 4% VAT would have generated about $379 million before any consideration of practical or political reductions in the base. This represents revenue as measured under the broadest possible consumption type VAT. Clearly, revenue would be less than this amount in the wake of administrative and political considerations that in all likelihood would act to reduce the tax base. If the full potential for revenue reduction at the national level described above were to occur at the state level, revenue would be reduced to $143.86 million in 1990. The extent of these reductions to the base would depend on the perceived need for additional revenue, as reflected in the tax rate adopted, and the effectiveness of special interests in lobbying the legislature. As will be shown below, these forces acted to reduce the tax base substantially in Michigan.

The above revenue estimate is very close to recent estimates of revenue that would be generated under a general retail sales tax. Sales tax revenue under the broadest of all possible sales tax bases was estimated at $377 million for tax year 1990 by staff of the Legislative Council. This is comparale to the estimate of $396 million under a broad-based consumption type VAT shown in Table 2.

An alternative method to guage the revenue potential from a value-added tax is to compare the size of Montana's economy with that of Michigan, and relate that comparison to revenue generated under Michigan's Single Business Tax (Table 3).

The top section of Table 3 shows Michigan total and disposable personal income in 1990. Revenue from the single business tax is also shown, and is expressed as a percentage of total and disposable personal income.

The middle section of Table 3 shows Montana total and disposable personal income in the same year. Also shown are estimates of what a Michigan-type VAT would have generated in Montana. A Michigan-type VAT would have generated about $126 million in Montana in 1990, at the Michigan tax rate of 2.35 percent.

The bottom section of Table 3 adjusts these revenue estimates to convert to an income-type VAT (Michigan has a consumption-type VAT), under both a narrow and broad base. The bottom section also adjusts the tax from the 2.35 percent rate to a 4 percent rate.[7]

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[7] In addition to the full deduction for capital purchases, Michigan provides for a host of tax expenditures within their VAT structure, including an exemption for small businesses, a labor intensity reduction, a gross receipts reduction, a small business credit, an unincorporated business credit, and a contribution credit. These tax expenditures are controlled for in the adjustment to a broad base tax. In 1981, these adjustments to the base, combined with the capital acquisition deduction, reduced tax liability an estimated $626 million. In relation to total revenue of $942 million in the same year, tax revenue would have been 66.4% higher in 1981 in the absence of these adjustments. Hence, the broad base multiplier of 1.664 in Table 3.

Based on the Michigan experience, a 4 percent, narrow-based, income-type VAT would have raised $292 million, while a broad-based VAT would have raised $356 million in 1990, in Montana.

Table 3
Estimate of Montana VAT Revenue Based on
Comparison to Michigan Economy and Michigan VAT Revenue
(Tax Year 1990, $ millions)

Michigan Total Personal Income[8]	170,385.0
Michigan Disposable Personal Income	148,083.0
Michigan Single Business Tax Revenue (2.35%)	1,829.5
Michigan Tax as % of Tax Base	
- Total Personal Income	1.07%
- Disposable Personal Income	1.26%
Montana Total Personal Income	11,709.0
Montana Disposable Personal Income	10,177.0
Montana VAT Revenue Before Adjustments (2.35%)	
- Total Personal Income	125.7
- Disposable Personal Income	125.7
Income-Type VAT Multiplier	
- Narrow Base	1.362
- Broad Base	1.664
Tax Rate Multiplier (4/2.35)	1.702
Montana VAT Revenue	
Income-Type VAT, **Narrow Base:**	
- Total Personal Income	291.5
- Disposable Personal Income	291.5
Income-Type VAT, **Broad Base:**	
- Total Personal Income	356.1
- Disposable Personal Income	356.1

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[8] Data sources for the information presented in Table 3 include *Annual Reports of the Michigan State Treasurer*, and various issues of *Survey of Current Business*, U.S. Department of Commerce.

The above estimates provide only a rough approximation of the revenue potential from a Montana value-added tax. The approach is necessarily simplistic due to the absence of the data necessary to conduct a more sophisticated analysis. Additional development of the databases and methodology necessary to provide more precise estimates of revenue should be a priority in further discussions of value added taxation in Montana. Nevertheless, the above estimates indicate that the VAT has the potential to rival Montana's current largest source of revenue--the individual income tax--in revenue generation.

Impact of a Value-Added Tax on Montana Corporations

Of fundamental concern to policymakers is the impact of tax changes on various sectors of the economy. Implementation of the Michigan Single Business Tax was accompanied by significant shifts in tax liability between corporations, partnerships, and sole proprietorships, as well as shift between industrial groups. Presently, data limitations preclude these types of analyses in Montana. However, it is possible to show the impact that a value-added tax would have on Montana's largest corporate taxpayers.

Table 4 shows the impact of a value-added tax on the top 50 corporations in Montana. In this case the top 50 is measured by Montana tax liability in 1989. Information for the same 50 corporations was gathered for the three years shown in the table.

The first two lines of the table show current law taxable income, and tax liability at the current law tax rate of 6.75 percent. Total tax liability averaged $23 million over the three-year period under current law.

The second section shows the value-added tax base, by major categories of the base--federal taxable income, compensation, and net interest, rent, dividends, and royalties. The treatment of rent follows the treatment in the national income accounts; that is, rent paid is included in the tax base, while rent received is excluded. Finally, the value-added tax base represented here is of the income type in that depreciation is not included in the tax base.

One obvious feature of the VAT is the enormity of the tax base. Over the three-year period in the table the VAT tax base was almost four times as large as the tax base under the current corporation income tax. A value-added tax levied at a 4% rate would have generated over two times the revenue generated under current law over this period.

The revenue-neutral VAT tax rate for these corporations would have been about 1.77 percent. In other words, to insure that the top 50 corporations would pay no additional tax as a group under a VAT, the rate for all businesses could be no higher than 1.77 percent. Based on the analyses done earlier, this would reduce revenue under a broad-based, income type VAT from around $356 million to $158 million. In this perspective, some of the trade-offs become apparent.

Table 4
Impact of Value-Added Tax on Montana Top 50 Corporations
(Tax Years 1988, 1989, and 1990; $ Millions)

	1988	1989	1990
Current Law			
Montana Taxable Income	326.0	370.7	326.1
Montana Tax @ 6.75%	22.0	25.0	22.0
Value-Added Tax Base			
Federal Taxable Income	370.0	391.0	343.7
Compensation	839.5	796.5	753.1
Net Interest, Rent, Dividends, and Royalties	129.1	135.3	132.6
Total Tax Base	1,338.5	1,322.7	1,229.4
Revenue @ 4%:	53.5	52.9	49.2
Change in Revenue:	31.5	27.9	27.2
Revenue-Neutral Tax Rate:	1.644	1.890%	1.789%

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Up to this point this report has focused on the need for tax reform in Montana, and how a value-added tax can be a viable , integral part of comprehensive tax reform. The report has discussed what a VAT is, the various types of VATs and which are most appropriate for state use, the potential for revenue generation under a VAT in Montana, and how a VAT might impact some of the largest corporations operating in Montana.

The second part of this report will focus more on some of the generally accepted principles of business tax policy, and how a VAT stands up to those principles in relation to corporate income or general sales taxes. A following section discusses several legislative pitfalls and other problems that may be encountered when enactment of a VAT begins to receive serious consideration.

The VAT and Principles of Tax Policy

Generally accepted principles of business taxation suggest that the business tax structure adopted should to as great an extent possible be equitable, simple, stable, neutral, efficient, and competitive.

Equity

Rationale for Business Taxation. That the value-added tax is generally considered to be a tax on "business" is apparent in the title of Michigan's VAT--the "single business tax". Of the many aspects to the equity principle, perhaps the most fundamental is why business should be taxed at all. The formal response is that, like individuals, businesses are the recipients of government services, including sanitation, transportation, and property protection services, and should pay for those services through taxes. In this sense, government is viewed as one of the factors of production, along with land, labor, capital, and entrepreneurship, with taxes being the payment to this factor much as rent, interest, wages, and profits are payments to the other factors of production.[9]

Ability-to-Pay vs. Benefits Principle. Given this rationale for taxing business, it then remains to be determined on what basis business should be taxed. In this regard there are two widely recognized principles: the "ability-to-pay principle" and the "benefits principle". The ability-to-pay principle suggests that tax burdens should be related to some measure of well being, regardless of the amount of government services consumed. The benefits principle suggests that taxes should be directly related to the amount and value of government services consumed.

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[9] In addition, there are practical reasons for levying taxes at the business level. Administratively, it is easier to levy a tax on income at its source (e.g., withholding) rather than at its end use. Also, levying taxes at the source of income enhances tax base accessibility.

With respect to business taxation, adherents to the ability-to-pay principle prefer net income as the proper measure of the tax base, as reflected in the current corporation income tax. Alternatively, adherents to the benefits principle of taxation prefer a tax base that better reflects the firm's use of government services and overall business activity. Value-added taxes are based more on the benefits principle of taxation; however, the Michigan VAT incorporates elements of both principles.

Proponents of value-added taxes (benefits principle) have noted several problems with the net income (ability-to-pay) approach to business taxation. First, ability to pay is more appropriately applied in a personal sense, in that it conotes a loss of well-being through personal sacrifice. As such, it is best applied in situations in which individual sacrifice can be measured, such as in the individual income tax. Second, net income is an elusive concept involving widely varying and arbitrary computations that in any event may not result in a good measure of the firm's ability to pay. Finally, net income bears no relation to the quantity of government services consumed. Firms with very low or no net profit pay little or nothing for the government services they consume in their production processes. While it is entirely appropriate to argue that these firms should not be unduly burdened by the tax structure, it is also appropriate thay they pay something for those government services they use in producing their products and services. Value added taxation, with appropriate safeguards built into the system, better achieves the goal of matching tax burdens with government services consumed.

Uniformity of Treatment. Value added taxation also receives high marks for uniformity of treatment. Under the current tax structure businesses face different treatment and tax rates depending on form of ownership. Under a VAT all businesses, regardless of business form (corporation, partnership, or sole proprietorship) are treated and taxed on the same basis, the amount of value they add to the general economy, at the same low rate.

In addition, the VAT does not discriminate between the different factors of production. The value of capital and labor are subject to the same tax burden.

Regressivity. Value-added taxes are often criticized by opponents as being regressive; that is, the percent of individual or household income used to pay the tax declines as incomes rise. This claim rests on the assumption that value-added taxes are fully shifted forward in the prices paid by purchases of both intermediate and final goods at all stages of the production process. In fact, the incidence of value added taxes is uncertain and open to debate.

While the VAT is generally characterized as a "business tax", it is often argued that businesses never pay taxes, only people pay taxes. In the case of business taxes the final incidence of the tax must fall on either the consumer in the form of higher prices, the employee in the form of lower wages and benefits, the stockholder in the form of lower dividends or lower stock value, or the proprietor in the form of lower profits. Who bears the burden will depend on prevailing conditions in the input markets for labor and capital, and the output market of the product being sold by the taxed firm. These factors alone make the incidence of VATs difficult to determine even in "closed" national economies. In "open" state economies the incidence of a VAT becomes even more elusive given the potential for exporting a significant portion of the tax through sales of products produced in the state, but purchased outside the state's borders.

At the state level, value-added taxes are likely to be less regressive than sales taxes, but more regressive than business income taxes. Value-added taxes are likely to be less regressive than retail sales taxes because of the greater potential for shifting the incidence of the tax to components other than price, and due to the greater exportability of the VAT. On the other hand there is probably a greater degree of shifting the incidence of the VAT forward onto price relative to a business income tax. Because profits are less predictable than value-added taxes, there is less opportunity to plan for shifting of profits onto prices.

To the extent that it is perceived to be a problem, there are several means of addressing the regressivity of value-added taxes. These include the use of differential rates, zero rating or exempting specific goods, reforming the income tax to make the overall system more progressive, providing for low-income refundable tax credits, and increasing direct expenditures to low-income households.

Differential rates, and zero rating or exempting certain goods or services, complicates administration considerably, reduces neutrality with respect to production decisions, and is not effective in targeting relief to specific groups. General reform of the income tax can offset regressivity to some extent, but does nothing for low-income households already exempt from the income tax. Increasing direct expenditures to low-income households effectively targets relief, but places responsibility for consumption decisions in the hands of the state. Providing refundable tax credits targets those groups most in need of relief, and leaves the consumption decisions in the hands of the consumers, who are best able to determine for themselves the goods and services needed.

Distributional Impacts. Issues of equity also focus on how implementation of a value-added tax, in addition to or as a replacement for other taxes, affects the distribution of tax liability across and within industry groups. Unfortunately, the data needed to conduct this type of analysis is not currently available. Nevertheless, information available from the Michigan experience and other VAT studies suggests that the tax burden would be shifted away from capital-intensive industries towards labor- and land-intensive industries. Generally, firms that are low-profit, labor-intensive would see an increase in their share of the total tax burden. These include firms in the agricultural, services, retail trade, and finance and insurance industries.

Simplicity/Ease of Administration

From the business standpoint, all of the information needed to file VAT forms is readily available. For corporations, this would mean having to file the VAT form, but no longer having to file the current income tax form (assuming the VAT is used to replace current corporation license taxes). For partnerships and sole proprietorships, however, implementing a VAT would mean the filing of a new form, in addition to the current forms already being filed for individual income tax purposes. Most of these firms would have to file new forms under a sales tax as well; however, the VAT form would probably be more complicated than a sales tax form if the Michigan experience is any indication.

From a state's administrative standpoint, implementing a VAT significantly increases the administrative burden, relative to both the current income taxes and a general retail sales tax. This is because implementing a VAT would require the filing and processing of more tax forms. Under a general retail sales tax only retailers have to file, but under a VAT all sellers in the business chain must file, which significantly increases the number of filers. This administrative burden can be reduced significantly, with a relatively small loss of tax revenue, by exempting very small firms from the VAT, as was done in Michigan.

Stability/Control

Both value-added taxes and general sales taxes provide for greater revenue flow stability than business income taxes. Retail sales fluctuate little compared to "profits", and including compensation in the VAT tax base imputes a great deal of stability, as wages and salaries tend to be stable through economic cycles, when income tends to fluctuate more. Perhaps the most important selling point in the Michigan discussion was the stability of the VAT relative to the corporate income tax experience in the years immediately preceeding implementation of the VAT. Stability is important in that it mitigates the need for rate changes and other legislative actions that are necessary when revenue flows become erratic.

A state is able to maintain a greater degree of control with respect to tax policy under a VAT, relative to income type taxes. Currently in Montana corporation income taxes use federal taxable income as their starting point, and make very few adjustments to arrive at Montana taxable income. To a great extent this means that the tax base is largely controlled by federal tax policy regarding exclusions, deductions, etc. Under a value-added tax, federal taxable income becomes a relatively small component of the tax base, greatly reducing the influence of federal tax policy on the state tax base.

Neutrality, Uniformity, and Efficiency

Neutrality, uniformity, and efficiency are all closely related topics, and these terms are often used interchangeably. In general, these terms are used to describe the extent to which a tax system treats industries or firms differently depending on whether they are labor-intensive or capital-intensive, whether they are large or small, whether they make greater use of debt or equity financing, etc. Sound tax policy strives to achieve neutrality and uniformity in order to maintain efficiency in the marketplace. An efficient tax system minimizes market distortions related to investment decisions, labor/capital ratios, and debt/equity ratios, while providing for adequate revenue at a reasonably low rate.

Value-added taxes can enhance these objectives considerably. Because the VAT is based more on the "size" of the firm rather than the "type" of the firm (corporation, partnership, or sole proprietorship) it reduces inequities that arise when different firms competing in the same markets face different tax rates purely due to differences in their form of ownership.

Montana's current law tax structure tends to tax capital more heavily than labor. For example, corporation license taxes are based on profits, corporate dividends are often taxed twice, and local taxes rely heavily on relatively high tax rates on business equipment and machinery. A value-added tax base includes both capital and labor components and taxes them both at one low rate.

Value-added taxes also provide for equal treatment of debt and equity financing by including both components in the tax base and taxing them at the same low rate. Current law income taxes tend to drive a tax cost wedge between equity and debt financing by allowing deductions for interest costs while taxing equity (dividends and profits).

Providing equal treatment of labor with respect to capital, and debt with respect to equity, by using one flat low rate acts to minimize the impact on investment decisions and overall economic behavior, and results in an efficient tax system.

Competitiveness

As noted above, Montana's current tax system imposes a heavy burden on capital accumulation. These disincentives for capital accumulation may dampen economic growth in cases where they provide a significant incentive to locate in neighboring jurisdictions. Most states have responded to the competition issue by providing for a plethora of tax incentives designed to retain firms, attract firms, etc. This need for special incentives detracts from simplicity, adds administrative complexity, and deteriorates fiscal certainty. Competition is heightened when the busines tax system is based on a single low rate that applies to all production, allows for long-range planning, and can be counted on not to be adjusted up and down erratically over time. Value-added taxes can provide this enhancement in competitiveness.

Issues Surrounding Value-Added Taxation

In general, value-added taxes fare relatively well in terms of meeting the requirements of a sound tax system. Yet, in spite of these qualities value-added taxes, with the exception of Michigan, are not used by the states. This is due in part to the fact that value-added taxes are a relatively new concept in taxation, and in part due to the general inertia that keeps all governments in tack. This general satisfaction with the way existing tax structures have been able to meet the needs of states has been waning lately, as states find it more and more difficult to maintain existing services with existing tax structures, and as the evidence begins to mount that current tax structures do not necessarily reflect the most appropriate tax structures given the changing nature of our national and local economies.

As value-added taxation begins to receive more attention, several questions will arise that have particular bearing on the political nature of the tax. All too often the answers to these types of questions become obfuscated in rhetoric that does little other than confuse the issues. The following section takes a look at some of the questions that are sure to be asked in regards to implementing a value-added tax, and attempts to provide a reasoned response that hopefully will help to clear the air of some common misperceptions regarding value-added taxes.

Is the VAT a "tax on a tax on a tax"?

Perhaps of all the things that a value-added tax is not, is that it is not a tax on a tax on a tax! In fact, value-added taxes were developed specifically to prevent the cascading or pyramiding tax effects that were inherent in gross receipts type taxes. The European Economic Community's 1967 decision to replace existing gross receipts taxes with value-added taxes was driven by the concern to end tax pyramiding. Those who assert that a value-added tax is a tax on a tax either fail to understand the VAT concept, or are confusing VATs with other taxes that do have a pyramiding tax effect, such as gross receipts taxes.

In fact, there is less pyramiding effect under a value-added tax than there is under a general retail sales tax. This is particularly true for retail sales taxes of the nature being contemplated in Montana, which are broad-based in that they include a significant number of services in the base. As Cline as noted, "The major problem with expanding the retail sales tax to include a comprehensive list of services is that a large percentage of services are purchased as business inputs. As already mentioned, if these purchases are included in the sales tax base, the tax becomes a gross sales tax with substantial pyramiding and undesirable economic distortions. In contrast, a consumption VAT would be equivalent to a comprehensive retail sales tax on goods and services without pyramiding.[10]

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[10] Robert J. Cline, "Should States Adopt a Value-Added Tax?", in *The Unfinished Agenda for State Tax Reform*, Steven D. Gold, ed., National Conference of State Legislatures,

Is the VAT a retail sales tax in disguise?

Value-added taxes produce the same economic results as a general retail sales tax only in national, or "closed" economies; and then, only when destination-based, consumption-type VATs are implemented.

In subnational "open" economies, i.e., states, value-added taxes are far different from sales taxes. This is because VATs are origin-based taxes designed to tax income at its source, regardless of where final consumption of goods and services occurs. That is why the VAT is levied at the business enterprise level to begin with. Retail sales taxes are destination-based taxes designed to tax production at its point of consumption. In practical terms, this difference boils down to residents of the taxing jurisdiction paying the retail sales tax, whereas the burden of value-added taxes is shared by nonresidents to the extent that final consumption occurs outside the taxing jurisdiciton; which leads to the next question.

What about exportability?

Exportability refers to the share of tax revenue accruing to a taxing jurisdiction that is paid by individuals and businesses residing outside the jurisdiction. Taxes can be exported in several different ways. The most obvious way is when products are sold to nonresidents in situations where the tax is fully shifted onto the price of the products sold. Taxes can also be exported when resident taxpayers are allowed to deduct the tax in question on their federal tax forms. A third method of exporting taxes occurs when taxes are shifted to the owners of capital or to workers who reside outside the taxing jurisdiction.

The degree to which a taxing jurisdiction will experience a net exportation of taxes depends on several factors including the extent to which the state is a net exporter or importer, the extent to which the types of taxes imposed are shifted forward or backwards relative to other forms of taxation, the extent to which exports and imports are subject to the same form of taxation, and the difference in tax rates between exporting and importing jurisdicitions.

With respect to value-added taxes, suffice it to say that the opportunity for exporting is significantly enhanced relative to a retail sales tax. Once again, this is due in large part to the origin-based nature of a VAT versus the destination-based nature of a sales tax. As has been noticed elsewhere, "...if the VAT is viewed as a benefit tax levied to pay for government goods and services provided to businesses, it follows that the tax should be based on production within a state. It also suggests that sales to out-of-state customers should be subject to VAT, but sales to state consumers and businesses by out-of-state firms should not be taxed. Under this production or origin version of the VAT, a state would tax a greater portion of the value of sales being sold out of state (and possibly a smaller portion

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Washington, D.C., November, 1988, p.239.

of imports) than under current retail sales and use taxes, which follow the destination principle of taxation.[11]

The federal Tax Reform Act of 1986 also enhanced the exportability of value-added taxes relative to retail sales taxes. That act repealed federal deductibility of state and local sales taxes for federal taxpayers who itemize. However, other business taxes, including value-added taxes, remain deductible. Value-added taxes could still be exported through the federal deductibility, while retail sales taxes could not.

Is the VAT a tax on business? on labor? on consumers?

Well, value-added taxes are collected by businesses so it must be a tax on business, right? But wait, retail sales taxes are also collected by businesses and we know that's a tax on consumers, right? But wait, in Michigan 70% of the VAT tax base is composed of compensation, so it must be a tax on labor, right? But wait, if the tax is fully shifted onto price it doesn't matter that businesses collect it, or what is used to measure the base, it's a tax on consumers, right?

The answer to all of the above questions: yes and no.

All taxes represent a levy on economic activity. Where the final incidence of the tax lies, particularly with respect to taxes levied at the business level, remains one of the great economic mysteries. There appears to be some indication that value-added taxes are believed to be shifted forward onto prices. Certainly, firms that enjoy a certain degree of monopoly power will have greater opportunities to reflect the tax in their prices, with the result being that the tax burden is borne by consumers.

But we also know that for those firms that are pure "price takers", e.g., agricultural firms, there is little or no opoportunity to set your own prices, with the consequence being that taxes must then be paid out of profits or reduced wages. Besides agriculture, other firms and industries have very little latitude in setting prices; and in these cases, too, taxes will be borne by either the owners of capital or labor.

If labor is able to exercise a significant amount of monopoly power, either through strong unionization or through the minimum wage laws, then the tax will be shifted to the owners of capital. But if labor is poorly organized and wages are above the minimum, then the opportunity exists for the tax to be borne by labor through reduced wages, or the foregoing or delaying of wage increases.

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[11] Ibid., p. 249.

In the final analysis, the incidence of value-added taxes is spread to all segments of the economy--owners of capital, labor, and consumers. The extent to which each of these segments end up bearing the tax will depend on conditions in the input and output markets for each good and service produced.

It is important to note that the final incidence of a value-added tax is similar to that of a retail sales tax, in that the final incidence of a retail sales tax is spread between consumers, labor, and profits also. Table 5 is reproduced from a study of the incidence of the Florida sales tax, published in July, 1992.[12]

Table 5
Incidence of the Florida Sales Tax Burden

Florida Households	67.9%
-Florida Labor	33.7%
-Florida Consumers (prices)	34.2%
Florida Business (capital)	7.2%
TOTAL FLORIDA	**75.2%**
Exported Out-of-State Visitors	6.7%
Exported to Business (capital)	11.9%
Exported to Households (labor)	6.3%
TOTAL EXPORTED	**24.8%**

The Florida study contains several interesting observations. First, of the total sales tax burden 59.1 percent is shifted backwards to businesses. Of this amount 19.1 percent is reflected in reduced profits, and 40 percent is reflected in reductions in employment and/or wages. Only 34.2 percent of the total sales tax burden is reflected in higher prices for Florida residents. Finally, only 6.7 percent of the total burden is paid by tourists. The study indicates that 25 percent of the total burden is exported out of state.

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[12] *Who Pays Florida's Sales Tax? An Empirical Examination of Florida's Sales Tax*, Florida Joint Legislative Management Committee, Economic and Demographic Division, July, 1992.

Will a "value-added tax" hinder Montana's ability to "add value" within the state?

(In recent years there has been considerable discussion of the extent to which tax rates and overall business tax structures actually have an impact on capital formation and business growth. Most of the studies in this area conclude that factors such as an educated labor force, ready access to capital, nearness to markets, and other market factors play a much more important role in the formation of capital and in business growth and development than does the state's tax structure. Nevertheless, the following discussion assumes that the state can influence capital formation and enhance a state's business growth and development through the application of an appropriate tax structure.)

This question is important given the emphasis in recent years on the need to add value to Montana's natural resources before shipping products out of state. Unfortunately, semantics tends to blur the issue in this regard. The argument goes that because a primary goal for Montana should be to "add value", then surely a "value-added tax" must be detrimental to that goal. To the contrary, depending on what the value-added tax is intended to do, and what type of VAT is used, implementation of a value-added tax can prove very conducive to adding value in Montana.

First, it's important to distinguish between value-added taxes and value-adding industries, or manufacturing. Traditional value-adding industries are those that convert raw materials (grain, cattle, minerals, trees, etc.) to intermediate (or final consumption) products before they are shipped out of state. Typically, these industries include very capital-intensive conversion plants such as smelters, meat processing plants, sawmills and other wood products plants, and other manufacturing plants. As such, they constitute but one segment of the total economy of the state.

When some people hear the term "value-added tax" they associate it with value-adding industries only. But within the context of a VAT, value-added refers not only to the above types of industries, but virtually to all economic or business activities including wholesaling, retailing, and most importantly, perhaps, service industries. After all, trade and service industries also add value to the economy. It is this extremely broad tax base that includes all business activity, not just value-adding (i.e., manufacturing) industries, that allows for a relatively low tax rate for all industries, including value-adding industries.

Second, how the VAT is structured, and what it is intended to accomplish is critical to its ability to stimulate value-adding industries. As was noted earlier, Montana currently tends to place a relatively heavy burden on capital investment through its corporate income and business personal property tax structure. A broad-based, low-rate, VAT designed to replace the current corporate income tax and substantially reduce or eliminate the tax on business equipment and machinery would dramatically reduce the tax burden on capital.

Implementing a consumption-type VAT that allows businesses to deduct fully capital purchases in the year acquired would provide an additional significant incentive for capital formation. Because firms and industries that add value to raw materials are typically capital-intensive, a consumption-type VAT designed purely as a replacement levy for the current corporate income tax and business personal property tax would provide a tremendous incentive for capital investment in value-adding industries. Cline has estimated that "a consumption-type value-added tax with immediate expensing of new capital investment provides many firms with approximately the same capital investment incentive created by the combination of the Investment Tax Credit and accelerated depreciation allowances repealed by the Tax Reform Act."[13]

The literature is replete with testimony from tax experts who believe that using a value-added tax to replace existing business taxes can provide an incentive for investment. Clearly, other scenarios exist. A VAT could be used to replace business income and property taxes, and in addition provide revenue for structural deficit reduction. In other scenarios value-added taxes could be used to do all the above, plus provide revenue for reducing individual income and property taxes. Of course, propositions of this nature require much higher VAT rates, and it is not at all clear that these types of scenarios would preserve the incentive for capital formation found in pure replacement tax scenarios.

How will a VAT impact on border states?

Value-added taxes should have relatively little impact on border states, and on border transaction activities. This is because value-added taxes are not specifically included as a component of the final sales price of goods and services, as are retail sales taxes. Also, as was discussed earlier, the final incidence of the VAT is more difficult to ascertain relative to a retail sales tax, at least from the viewpoint of the consumer who is all too aware of the retail sales tax component in the final sales price.

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[13] Ibid., p. 237.

Concluding Remarks

This paper was produced to provide legislators, tax administrators, and other concerned parties with information that will allow an assessment of the possibility of using the value-added tax as a means of reforming Montana's tax structure. The extent to which a VAT can be used to reform the current tax structure will depend in large part on the revenue-generating capabilities of a VAT, and what the VAT is intended to accomplish.

A value-added tax could generate revenue sufficient to replace current corporate income taxes and business personal property taxes, and perhaps provide additional revenue to provide for deficit reduction, while at the same time greatly enhancing the state's business climate by providing strong incentives for capital investment.

It is unlikely that a VAT could be used to provide revenue sufficient to substantially reduce individual income and property taxes as well, without jeopardizing the goals of enhancing the state's overall business tax stucture and competitive position. Besides, the notion of using a "business" tax to provide for "individual" tax relief would in all likelihood present insurmountable stigmatic perceptual problems.

Nevertheless, a value-added tax remains a viable component in comprehensive tax reform to the extent that it is used to replace existing taxes and enhance the state's business climate and competitive position. Legislators will have to grapple with issues of how to appease those groups that will perceive themselves to be treated unfairly by a VAT; namely, labor, small business, service sector businesses, etc. But as Michigan has shown, these problems are not insurmountable.

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